TRANSCRIPT OF RECORD

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1936

No. 824

W. A. THOMAS, COLLECTOR OF INTERNAL REVENUE, PETITIONER

vs.

J. J. PERKINS ET AL.

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FIFTH CIRCUIT

PETITION FOR CERTIORARI FILED MARCH 17, 1937

CERTIORARI GRANTED APRIL 5, 1937

SUPREME COURT OF THE UNITED STATES

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INDEX

	Original	Print
Proceedings in U. S. C. C. A., Fifth Circuit	A	1
Caption [omitted in printing]	A	1
Stipulation as to printing record	1	1
Record from D. C. U. S., Northern Texas	6	4
Caption [omitted in printing]	6	4
First amended petition	6	4
Recital as to exhibit A	14	8
Defendant's answer to first amended petition	15	9
Motion of plaintiffs for judgment	21	13
Judgment	21	14
Opinion of the Court, Atwell, J	23	14
Motion for extension of term of court to file bill of exceptions, etc., and order granting same	30	19
Bill of exceptions	31	20
Caption	31	20
Evidence for plaintiffs:		
Testimony of J. J. Perkins	32	20
Exhibit plaintiffs' no. 1—Assignment of oil and gas leases from Mamie S. Hammonds et al., to Faith Oil Corp., dated July 24, 1931	33	21
Exhibit plaintiffs' no. 2—Oil and gas lease, B. B. Fenton and wife to J. A. Reynolds, dated July 29, 1930	36	23
Exhibit plaintiffs' no. 3—Oil and gas lease, from J. C. Barrett to J. A. Reynolds, dated August 26, 1929 (Omitted) (same as exhibit no. 2)	42	26

	Original	Print
Record from D. C. U. S., Northern Texas—Continued.		
Bill of exceptions—Continued.		
Evidence for plaintiffs—Continued.		
Testimony of J. J. Perkins—Continued.		
Exhibit plaintiffs' no. 4—Oil & gas lease from J. J. Fuller and wife to Mamie S. Hammonds, dated September 22, 1930 (omitted) (same as exhibit plaintiffs' no. 2)	42	26
Exhibit plaintiffs' no. 5a—Oil and gas lease, Faith Oil Corp. to J. J. Perkins, dated June 4, 1932	43	27
Exhibit plaintiffs' no. 5b—Oil and gas lease, Faith Oil Corp. to J. J. Perkins, dated June 20, 1932	46	29
Exhibit plaintiffs' no. 6—Transfer order, Magnolia Petroleum Co., dated June 20, 1932	51	32
Exhibit plaintiffs'—Division order, Stanolind Crude Oil Purchasing Co., dated August 1, 1933	54	34
Exhibit plaintiffs' no. 6a—Division order, Simms Oil Co., dated May 10, 1933	58	36
Exhibit plaintiffs' no. 6b—Notation being the same in words and figures as plaintiffs' exhibit 6a	62	39
Exhibit plaintiffs' no. 6c—Division order, Simms Oil Co., dated June 27, 1932	62	39
Exhibit plaintiffs' no. 7—Oil and gas lease between E. H. Brawley and wife to W. J. Green, dated October 21, 1931	66	41
Exhibit plaintiffs' no. 8—Division order, Humble Oil & Refg. Co., dated August 12, 1932	74	45
Exhibit plaintiffs' no. 9—Quit-claim deed, W. O'Brien and Wife to J. J. Perkins, dated November 8, 1925	78	48
Exhibit plaintiffs' no. 10—Assignment of oil and gas minerals from W. O'Brien, et al., to Amarillo Oil Co., dated October 1933	82	50
Exhibit plaintiffs' no. 11—Photostat of sketch	87	53
Stipulation of parties that in their 1933 income tax returns, Mr. and Mrs. Perkins reported a net ordinary income for both of them of $42,993.74, etc	96	58
Motion of plaintiff for judgment	97	59
Motion of defendant for judgment	97	59
Additional testimony on behalf of plaintiffs:		
Testimony of J. J. Perkins	97	59
Exhibit A—Letter, Commissioner of Internal Revenue to J. J. Perkins, dated December 16, 1935	99	60
Colloquy between counsel and court	102	62
Testimony of J. L. McMahon	110	67
Portions of deposition of C. H. Clark	112	68
Balance of testimony of C. H. Clark	114	69
Testimony of—George H. Abbott	122	74
J. J. Perkins (recalled)	126	76

	Original	Print
Record from D. C. U. S., Northern Texas—Continued.		
Bill of exceptions—Continued.		
Evidence for defendant:		
Statement made by Mr. Blackstrom, atty. for defendant	127	77
Colloquy between counsel and court	127	77
Exhibit B (also marked pltffs.' D-2)—Calculation made by the Commissioner, and carried into his final calculation of tax liability, showing the amount of expenses which he allowed Mr. and Mrs. Perkins, etc	129	78
Testimony of J. J. Perkins (recalled)	131	78
Colloquy between counsel and court	132	79
Evidence for plaintiffs:		
Exhibit C—Notice of disallowance of claim by Commissioner of Internal Revenue to J. J. Perkins, dated January 10, 1936	135	81
Exhibit—Letter, Commissioner of Internal Revenue to J. J. Perkins dated December 16, 1935 (omitted) (same as exhibit A)	136	81
Exhibit—Statement attached to the claims for refund of income taxes paid for the calendar year 1933, etc	136	81
Exhibit—Assignment of oil and gas leases from Mamie S. Hammonds et al. to Faith Oil Corp., dated July 24, 1931 (omitted) (same as exhibit plaintiffs' no. 1)	140	83
Exhibit—Claim for refund by J. J. Perkins, November 7, 1935	140	84
Order approving bill of exceptions	144	87
Petition for appeal, order allowing same and fixing amount of bond	145	87
Assignment of errors	146	88
Appeal bond [omitted in printing]	151	91
Citation on appeal and acknowledgment of service thereon [omitted in printing]	153	91
Praecipe for transcript of record	154	91
Clerk's certificate [omitted in printing]	157	92
Record on cross-appeal from D. C. U. S., Northern Texas	158	
Caption [omitted in printing]	161	92
Defendant's application for extension of time and order thereon	162	92
Petition for appeal	163	93
Order allowing appeal	165	93
Assignment of errors	166	94
Waiver of issuance and service of citation on appeal	167	94
Praecipe for record	168	95
Clerk's certificate [omitted in printing]	169	95
Minute entries of argument and submission	170	95
Opinion, Sibley, J	174	96
Judgment	182	100
Clerk's certificate	184	101
Order allowing certiorari	185	101

A [Caption omitted.]

1 In United States Circuit Court of Appeals for the Fifth Circuit

No. —

J. J. PERKINS, ET AL., APPELLANTS

vs.

W. A. THOMAS, COLLECTOR OF INTERNAL REVENUE, APPELLEE

Stipulation regarding printing of the record

Filed August 7, 1936

The parties to the above styled proceeding, acting herein by and through their attorneys of record, hereby agree and stipulate that certain portions of the record in this cause, hereinafter designated, shall not be printed, because the same represent duplications or immaterial matters, and the Clerk is directed to omit the matters hereinafter specified in printing said record and to insert, in lieu thereof, the notations hereinafter shown.

The portions to be omitted and the notations to be inserted in lieu thereof are as follows:

I

Omit entirely the exhibit attached to Plaintiffs' First Amended Original Petition and insert, in lieu thereof, the following:

"Exhibit A omitted because identical with Plaintiff's Exhibit No. 1 shown elsewhere in the record."

2 II

Omit from the first full paragraph, beginning on page 5 of the Bill of Exceptions, down to the first full paragraph beginning on page 11 thereof, and insert the following notation:

"Detailed descriptions of oil and gas leases omitted in printing because the same are immaterial to any issue. The instrument assigned oil and gas leases made by the following original lessors: D. W. McQueen and wife; J. J. Fuller and wife; E. E. Stone and wife; J. C. Barrett, B. B. Fenton; Mrs. Lucille Thrasher et al; J. M. Hamby and wife."

III

Omit all of pages 13 and 14 and down to the paragraph on page 15 beginning with the words "Mr. Weeks", and insert, in lieu thereof, the following:

"Acknowledgments and recording data omitted because immaterial."

IV

Omit from page 22, beginning with the words "single acknowledgment", through and including page 24, and insert the following in lieu thereof:

"Acknowledgments and recording data omitted because immaterial."

V

Omit all of Plaintiffs' Exhibit 3, beginning on page 25 and extending to page 34, and insert the following:

"This Exhibit was an oil and gas lease from J. C. Barrett to
3 J. A. Reynolds, dated August 26, 1929, and, except as to parties and descriptions, is identical with Exhibit 2 and is therefore omitted."

VI

Omit all of Plaintiffs' Exhibit 4, beginning on page 34 and extending down to the phrase "the witness" on page 44, and insert in lieu thereof the following:

"This Exhibit was an oil and gas lease from J. J. Fuller and wife to Mamie S. Hammonds, dated September 22, 1930, and, except for parties and descriptions, is identical with Plaintiffs' Exhibit 2, and is therefore omitted in printing."

VII

Omit all of page 49 and that portion of page 50 down to the words "Plaintiffs' Exhibit 5–b", and insert the following in lieu thereof:

"Acknowledgments and recording data omitted because immaterial."

VIII

Omit all of page 54 and down to the phrase "The witness" on page 55, and insert in lieu thereof the following:

"Acknowledgments and recording data omitted because immaterial."

IX

Omit from page 65 beginning with the words "W. P. Luse" through page 67, and insert in lieu thereof the following:

"Division of royalty interest omitted because immaterial."

4 X

Omit from the top of page 70 down to the words "Plaintiffs' Exhibit 6–b" at the bottom thereof, and insert in lieu thereof the following:

"Detailed description omitted because immaterial."

XI

Omit from page 76 beginning with the words "Being a part of the Jackson Couch Survey" down to the phrase, on page 77 beginning "it is understood and agreed, etc.", and insert in lieu thereof the following:

"Detailed description omitted because immaterial."

XII

Omit from the close of the phrase, on page 99, beginning "In testimony whereof witness our hands this the _____ day of October, A. D. 1933", down to the phrase, on page 102, "The witness" and insert in lieu thereof the following:

"Acknowledgments and recording data omitted because immaterial."

XIII

Omit from the top of page 162 down to the phrase, on page 164, beginning "statement attached to the claims for refund, etc.", and insert in lieu thereof the following:

5 "Omitted because identical with Plaintiffs' Exhibit A."

XIV

Omit from page 168 beginning with the words "State of Texas, County of Gregg" down to the word "claim" on page 174, and insert in lieu thereof the following:

"Omitted because identical with Plaintiffs' Exhibit 1."

Executed July 31, 1936.

Staley Building, Wichita Falls, Texas.

HARRY C. WEEKS,
Attorney for Appellants, J. J. Perkins and Mrs. Lois Perkins.
CLYDE O. EASTUS,
J. G. B.,
FRANK B. POTTER,
J. G. B.,
J. L. BACKSTROM,
Attorneys for Appellee, W. A. Thomas, Collector of Internal Revenue.

6 In United States District Court, Northern District of Texas

[Caption omitted.]

No. 4843—At Law

J. J. PERKINS AND WIFE, MRS. LOIS PERKINS

vs.

W. A. THOMAS, COLLECTOR OF INTERNAL REVENUE

First amended original petition

Filed May 23, 1936

To the Honorable Wm. Hawley Atwell, Judge of the District Court of the United States for the Northern District of Texas:

Now come J. J. Perkins and Mrs. Lois Perkins, the plaintiffs in the above styled and numbered cause, and leave of the Court being first had and obtained, file this their First Amended Original Petition, in lieu of their Original Petition filed herein on December 28, 1935, and for such amended petition plead as follows:

I

7 Now come J. J. Perkins and Mrs. Lois Perkins, who will be hereinafter styled plaintiffs, complaining of W. A. Thomas, Collector of Internal Revenue, who will be hereinafter styled defendant, and respectfully allege:

II

The plaintiffs, J. J. Perkins and Mrs. Lois Perkins, are now, and were at all times hereinafter referred to, husband and wife. They, and each of them, are citizens of the United States and reside in Wichita Falls, Wichita County, Texas, which is within the Northern District of Texas. The defendant, W. A. Thomas, is now, and was at all of the times hereinafter referred to, the duly appointed, qualified and acting Collector of Internal Revenue for the Second Collection District of Texas. His office, as well as his place of residence, is in Dallas, Dallas County, Texas, which is within the Northern District of Texas. All of the acts and conduct of the said W. A. Thomas hereinafter complained of were done and performed in his official capacity as such Collector.

III

This suit arises under the Constitution and Laws of the United States, in that it is a suit brought to recover federal income taxes collected by the defendant from the plaintiffs under and by force of the Laws of the United States.

IV

Plaintiffs show to the Court that throughout the year 1933, as well as for many years prior thereto, they lived together as husband and wife in Wichita Falls, Texas, and during that year they owned various properties which constituted their community property under the laws of Texas, and received from said property, and from
8 other sources, income which was their community property under the laws of Texas, so that, by virtue of the provisions of the Revenue Act of 1932, they were required to file income tax returns and to pay income taxes to the United States of America. These income tax returns were filed for the year 1933 upon a basis of the calendar year 1933, and upon the basis of cash receipts and disbursements. Each of the plaintiffs filed a separate tax return and therein reported a total net income, subject to taxation, of $75,078.58; one half of which was reported by the Plaintiff, J. J. Perkins, as his share of the community income, and the other one-half of which was reported by the plaintiff, Mrs. Lois Perkins, as her share of the community property and income. Thereafter, and in due course, the plaintiffs paid in installments to the defendant the amount of taxes shown to be due by their respective returns; the dates and amounts of such payments being as follows;

By the Plaintiff, J. J. Perkins:	
March 14, 1934	$25.00
April 12, 1934	742.47
June 13, 1934	792.60
September 12, 1934	755.04
December 12, 1934	755.03
Total	$3,070.14
By the Plaintiff, Mrs. Lois Perkins:	
March 14, 1934	$25.00
April 12, 1934	750.47
June 13, 1934	800.60
September 12, 1934	763.04
December 14, 1934	763.03
Total	$3,102.15

These returns and payments were made by the plaintiffs, and
9 each of them, in a faithful and bona fide effort to comply with the law fixing their income tax liability for said year and to discharge the liabilities so fixed.

V

Thereafter, the books and records of the plaintiffs were audited by representatives of the Bureau of Internal Revenue to determine the accuracy and correctness of said returns, and, based upon this examination, the Commissioner of Internal Revenue determined and fixed the total net community income of the plaintiffs as $93,588.22, and the equal share of the same, upon which each of the plaintiffs was taxable at $46,794.11. Based upon this determination

he made an assessment of additional income taxes for the year 1933 against the plaintiffs, and each of them; the amount of additional taxes assessed against each being $1,316.37. Plaintiffs say that said additional assessments were made on or about October 24, 1935. Thereafter, and in due course, said assessments were certified by the Commissioner of Internal Revenue to the defendant Collector at Dallas for enforcement and collection, and the plaintiffs paid the defendant Collector, on or about October 24, 1935, the additional tax so assessed, together with interest thereon; the interest collected from each of the plaintiffs at said time amounting to $125.70.

VI

Plaintiffs further say that the additional tax so assessed and collected from the plaintiffs, and each of them, was erroneous, illegal, and excessive, in that it was based upon items of alleged income which were not, under the Revenue Act of 1932, taxable to the plaintiffs, or either of them, and upon the disallowance of deductions from gross income to which the plaintiffs, and each of them, were entitled under the Revenue Act of 1932, all of which is more fully shown by the facts hereinafter alleged.

10 VII

(a) In the year 1933, the plaintiffs owned as their community property a 3/8ths share in a certain interest in oil and gas leaseholds on lands in Gregg and Upshur Counties, Texas. Certain of these interests had been acquired by plaintiffs through the Faith Oil Corporation and under and through an assignment thereof made to Faith Oil Corporation on or about July 24, 1931. There is attached hereto and marked Exhibit "A" a copy of said assignment, which is true and correct in each and every detail, save and except that the detailed description of the lands covered is omitted as immaterial. Said exhibit is hereby made a part hereof for all purposes. By virtue of the terms of said assignment, one fourth of all of the oil to be produced from said property was to go to the assignors in said instrument until they had received oil of the value of $395,000.00. Such rights to oil to be produced under oil and gas leases are usually referred to and known to those engaged in the business of producing oil as an "oil payment."

(b) In addition to the interests so acquired, the plaintiffs likewise owned and held, in 1933, an undivided 3/8ths interest in a certain oil and gas lease on lands in Upshur County, Texas, acquired with Faith Oil Corporation and W. J. Green under an oil and gas lease executed by E. H. Brawley and wife to W. J. Green, which oil and gas lease provided, in addition to the cash consideration that the lessors should receive 1/4th of 7/8ths of all of the oil to be produced therefrom until they had received oil of the value of approximately $45,000.00.

(c) The plaintiffs held, as above stated, under said assignments and leases throughout the year 1933, an undivided 3/8ths interest in such rights as were conveyed thereby and participated in
11 the operation of said properties for oil and gas throughout the year. There was produced throughout said year oil in sufficient quantities to that, on account of that portion of said oil payments respectively applicable to the 3/8ths interests of the plaintiffs, the holders of said oil payments received oil of the value of $9,614.52. In the determination of the plaintiffs' net income and alleged additional tax liability for the year 1933, made by the Commissioner of Internal Revenue heretofore set forth, that official treated said sum of $9,614.52 as a part of the gross income of plaintiffs and thereby increased their community income by said sum of, to-wit, $9,614.52.

VIII

Plaintiffs say that no part of the oil which went to the aforesaid assignors to apply upon said oil payment was, or had ever been, the property of the plaintiffs. On the contrary, that portion of said oil was, when produced and sold, the property of the said assignors or lessors, and said oil, as it was produced, was placed in tanks upon the various tracts from which it was produced for the account, and for the use and benefit, of said assignors or lessors and was thereafter run from said lease storage tanks into various oil pipe lines to the credit of said assignors, or lessors, and was sold by them when and as they saw fit and under such terms and conditions as they saw fit, and payment therefor was made directly to said assignors or lessors. All of this was in accordance with a well established trade practice and custom by which, in the case of such oil payments, the holder thereof is considered, deemed, and treated by all of those dealing with such oil and gas leases, or the oil produced therefrom, as the owner of a fractional portion of the oil in and under the leased premises and produced therefrom, and as
12 entitled to receive the oil in kind and dispose of same. Because of these facts, the aforesaid increase in the community income of the plaintiffs, and each of them, was erroneous and illegal.

IX

Plaintiffs would next show to the Court that in the year 1924, they acquired, as their community property, an undivided one third (1/3) interest in certain lands in Moore County, Texas, known as the Ozier Ranch, embracing approximately 5,400 acres. The plaintiffs acquired the aforesaid interest in and to the fee simple title to said lands. Record title, in accordance with a contract, was acquired in 1925. Both in 1924 and 1925, the principal value of said lands was their prospective and potential value for the production of oil or gas, and at said times it was considered by all of those informed as to the possibilities and probabilities of producing oil or gas in this area of Texas that said lands, or a substantial portion

thereof, would produce oil or gas in paying quantities, and, but for the value attributable to and attaching to said lands on account of the fact that the same would probably produce oil or gas, and but for the then market value of the minerals in and under said land, the plaintiffs would not have purchased or acquired any part or interest therein. The plaintiffs paid for said interest the sum of $10,000.00 and plaintiffs say that at least 3/4ths of said purchase price represented and was the cost of the oil, gas, and mineral content of said land. In the year 1933, the taxpayers sold and conveyed all of their interest in the oil, gas, and other minerals in and under said land and received therefor $31,073.33. In their said income tax returns for the year 1933 they reported this sum as the gross receipts from said sale, and in fixing and reporting the profit therefrom deducted as the cost of the mineral interest so sold the sum of $7,500.00, which was, as plaintiffs allege
13 and believe, the portion of the cost of said undivided one third interest in said lands attributable to and properly allocatable to the minerals so sold and conveyed.

X

In determining the plaintiffs' community income for the year 1933, the Commissioner of Internal Revenue disallowed said deduction of $7,500.00, and treated the total sale price of $31,073.33 as income from said sale taxable to the plaintiffs, thereby increasing their community income by the sum of $7,500.00.

XI

Plaintiffs say that in determining the taxable income and gain from said sale, they are, under and by virtue of the Revenue Act of 1932, entitled to deduct from the selling price of said property the cost thereof, and that the acts and conduct of the Commissioner of Internal Revenue in so increasing their taxable net income were erroneous and illegal.

XII

Plaintiffs say that because of these facts, they are entitled to have and recover of and from the defendant so much of the income taxes and interest paid by them to the defendant, as heretofore set forth, as is attributable to the two items heretofore referred to, and plaintiffs say, upon information and belief, that all of the tax and interest paid to the defendant, Thomas, on or about October 24, 1935, is attributable to the aforesaid errors.

XIII

Plaintiffs further show to the Court that on or about
14 November 8, 1935, they, and each of them, filed with the defendant Collector written claims for the refunding of such taxes and interest; said claims, and each of them, being based upon

the same facts and claims as are herein set forth. Thereafter, said claims, and each of them, were considered by the Commissioner of Internal Revenue, and, on or about December 16, 1935, each of said claims was rejected and disallowed by the Commissioner of Internal Revenue.

XIV

Plaintiffs further say that all of the acts and conduct of the defendant herein complained of were done by him in his official capacity as Collector of Internal Revenue and under instructions from his superior officers, and that on this account, the said defendant is entitled to a Certificate of Probable Cause for his said acts.

Wherefore, premises considered, plaintiffs sue, pray for service to defendant, and that, upon final hearing hereof, they have judgment against defendant for the taxes and interest so collected from them on October 24, 1935, together with interest from the date of payment as provided by law, and all costs of suit; and that the defendant be awarded a Certificate of Probable Cause; and that the plaintiffs have such other and further relief, special and general, as they may be entitled to receive under the facts alleged.

(Signed) HARRY C. WEEKS,
WEEKS AND MORROW,
Attorneys for Plaintiffs.

Staley Building, Wichita Falls, Texas.

EXHIBIT A—Omitted because identical with Plaintiffs' Exhibit No. 1 shown elsewhere in the record, as per stipulation of counsel copied at page one hereof.

* * * * * * *

In United States District Court

Defendant's answer to first amended petition

Filed June 9, 1936

Now comes W. A. Thomas, Collector of Internal Revenue, defendant in the above entitled and numbered cause, by and through Clyde O. Eastus, United States Attorney for the Northern District of Texas, and demurs generally to plaintiffs' cause of action and says the same is insufficient in law to entitle plaintiffs to judgment, and of this he prays the judgment of the Court.

(S.) CLYDE O. EASTUS,
United States Attorney,
(S.) FRANK B. POTTER,
Assistant United States Attorney,
(S.) J. L. BACKSTROM,
Special Attorney,
Treasury Department.

Defendant denies all and singular the material allegations in plaintiffs' petition contained, except those hereinafter specially admitted, and says the same are untrue, and demands strict proof thereof, and of this he puts himself upon the country.

(S.) CLYDE O. EASTUS,
United States Attorney,
(S.) FRANK B. POTTER,
Assistant United States Attorney,
(S.) J. L. BACKSTROM,
Special Attorney,
Treasury Department.

16 Answering further herein, if further answer be deemed necessary, defendant denies and alleges as follows:

I

Defendant admits the allegations contained in Paragraph II of plaintiffs' first amended petition.

II

Defendant admits the allegations contained in Paragraph II of plaintiffs' first amended petition.

III

Defendant admits the allegations contained in Paragraph III of plaintiffs' first amended petition.

IV

(a) Defendant admits the allegations contained in Paragraph IV (a) of plaintiffs' first amended petition.

(b) Defendant denies the allegations contained in Paragraph IV (b) of plaintiffs' first amended petition.

V

Defendant admits the allegations contained in Paragraph V of the first amended petition except that it is alleged that the additional taxes assessed against the plaintiffs of $1,316.37 for the calendar year 1933 were assessed on October 15, 1935, and that the plaintiffs paid said tax and interest on October 25, 1935.

VI

Defendant denies each and every allegation contained in Paragraph VI of plaintiffs' first amended petition.

17

VII

Defendant admits the allegations contained in Paragraph VII of the first amended petition, but denies that any claim for refund has been filed on account of any tax paid by the plaintiffs relative to the income in controversy derived from the lands in Upshur County, Texas, as alleged in said Paragraph VII, subdivisions (a), (b), and (c), and denies that by virtue of the terms of the Assignment, attached to the petition and marked Exhibit A, one-fourth of all the oil to be produced from said property was to go to the assignors until they had received oil of the value of $395,000.00 and also denies the similar allegations in Paragraph VII (b) as to the Upshur County lease.

VIII

Defendant denies each and every allegation contained in Paragraph VIII of plaintiffs' first amended petition.

IX

Defendants admits that the plaintiffs, in the year 1924, acquired as their community property an undivided interest in and to the fee simple title to certain lands in Moore County, Texas, known as the Ozier Ranch, embracing approximately 5,400 acres. Defendant denies that the principal value of said lands was their prospective and potential value for the production of oil or gas in this area or on said lands at that time. Defendant denies that plaintiffs would not have purchased any interest in said lands were it not for the possibility of oil or gas production. Defendant admits that the plaintiffs paid for said interest in said lands in 1924 the sum of $10,000.00. Defendant denies that at least three-fourths of said purchase

18 price represented and was the cost of the oil and gas and mineral contents of said land, and expressly alleges that no part of said purchase price represented or was the cost of any oil, gas, or mineral contents in said land. Defendant admits that in 1933 the plaintiffs sold and conveyed all of their interest in the oil, gas, and other minerals under said land for a price of $31,073.33 received by them. Defendant admits that the plaintiffs reported the said purchase price of $31,073.33 in their schedule of Item 30 in their income tax return for the calendar year of 1933 in computing their capital net gain and admits that they deducted from the capital gain so reported the sum of $7,500.00 as the alleged cost of their interest in said lands, attributable and allocable to the minerals so sold and conveyed.

X

Defendant admits the allegations contained in Paragraph X of plaintiffs' first amended petition.

XI

Defendant denies each and every allegation of Paragraph XI of plaintiffs' first amended petition.

XII

Defendant denies each and every allegation of Paragraph XII plaintiffs' first amended petition.

XIII

Defendant denies that the plaintiffs on or about November 8, 1935, filed with the defendant written claims for the refunding of taxes and interest based upon the same facts and claims as alleged in the first amended petition. The defendant admits that on or
19 about November 8, 1935, plaintiffs filed with the defendant written claims for the refunding of additional taxes paid by them for the year 1933 based upon some of the facts alleged in the first amended petition, but denies that said claims for refund are based upon the facts and contentions relative to the income derived from certain oil and gas leases on lands in Upshur County, Texas, as alleged in Paragraph VII of said first amended petition. The defendant admits that said claims and each of them were considered by the Commissioner of Internal Revenue and were on or about December 6, 1935, rejected and disallowed by the Commissioner of Internal Revenue.

XIV

Defendant admits that all of the acts and conduct of defendant herein were done by him in his official capacity as Collector of Internal Revenue for the Second Collection District of Texas, and under instructions from his superior officers, and that on this act the said defendant is entitled to a "Certificate of probable cause for his said acts."

XV

In the alternative, defendant says in the event it is held that said amount of $9,614.52 of so-called oil payments should not be included in plaintiffs' taxable income, defendant submits that the depletion allowed by the Commissioner of Internal Revenue as a deduction on account of said so-called oil payments should not be allowed. In the determination of plaintiffs' tax for 1933, the Commissioner of Internal Revenue allowed depletion in the amount of $2,919.16 on account of including said amount of $9,614.52 in plaintiffs' taxable income and, therefore, if said amount of $9,614.52 is eliminated from taxable income, the said amount of $2,919.16 allowed as depletion in respect thereof should be disallowed as a deduction in the determination of any refund found by the Court.

20 XVI

In the alternative, defendant further alleges, in the event it is held that said amount of $9,614.52 of so-called oil payments should not be included in plaintiffs' taxable income, that the expenditures made by the plaintiffs in recovering one-fourth of the oil, which oil plaintiffs contend did not belong to them and which expenditures have been allowed by the defendant as deductions in computing petitioners' income taxes for 1933, were erroneously allowed as such deductions. In the determination of plaintiffs' income tax for 1933 the Commissioner of Internal Revenue allowed as deductions the sum of $17,384.85 as expenses spent by plaintiffs in connection with the operation of the leases from which the said sum of $9,614.52 was derived, and that therefore the sum of $4,346.21 (one-fourth of the total expenditures of $17,384.85) represents the plaintiffs' expenditures in connection with the one-fourth of the oil alleged to belong to the plaintiffs' assignors. The defendant therefore alleges that said deduction, amounting to $4,346.21 allowed to the plaintiffs, should be disallowed in determining any refund found by the Court.

Wherefore, defendant having fully answered the first amended petition of plaintiffs herein, prays that plaintiffs take nothing by reason of their suit against him and that he be permitted to go hence without day and recover for costs.

(S.) CLYDE O. EASTUS,
United States Attorney,
(S.) FRANK B. POTTER,
Assistant United States Attorney,
(S.) J. L. BACKSTROM,
Special Attorney,
Treasury Department.

21 In United States District Court

Plaintiffs' motion for judgment

Filed June 11, 1936

To the Honorable Judge of said Court:

Now come the plaintiffs in the above styled and numbered cause and, after the evidence has been heard by the Court, move the Court to render judgment in favor of the plaintiffs for the amount sued for, with interest and costs as provided by law, for under the undisputed facts and the law the plaintiffs are entitled to recover the tax and the interest sued for, together with their costs.

(Signed) HARRY C. WEEKS,
Attorney for Plaintiffs.

WEEKS AND MORROW,
Wichita Falls, Texas,
Of Counsel.

In United States District Court

Judgment

Filed June 19, 1936

This cause came on regularly to be heard on June 11, 1936. The parties appeared, in person and by their attorneys, and announced ready for trial. A jury was waived in writing and all matters of fact, as well as of law, were submitted to the Court. The Court thereupon heard the pleadings and the evidence.

At the conclusion of the evidence, each party moved the Court for judgment in favor of such party. The Court then heard the argument of counsel.

22 Upon consideration of these motions, as well as the pleadings, the evidence and the argument of counsel, the Court determined that the issue presented as to the amount of taxable profit derived by plaintiffs from the sale of their interest in the minerals in and under the west one-half of the Ozier Ranch should be determined in their favor. The Court further determined that they should not prevail as to the other issues presented by them and that their motion for judgment should be granted in part and denied in part and that the defendant's motion for judgment should be granted in part and denied in part. It was accordingly so ordered.

To this, both parties in open Court duly excepted and had their exceptions noted of record.

It is, Therefore, Ordered, Adjudged, and Decreed by the Court that the plaintiffs, J. J. Perkins and wife, Mrs. Lois B. Perkins, do have and recover of and from the defendant, W. A. Thomas, the Collector of Internal Revenue for the Second Collection District of Texas, the sum of one thousand twenty six and 56/100 ($1,026.56) Dollars, together with interest thereon from October 25, 1935, until paid at the rate of six (6%) percentum per annum, and all costs of suit, applicable to issue decided for plaintiffs.

It appearing to the Court that the aforesaid sum was collected by the defendant from the plaintiffs in his aforesaid official capacity as income taxes for the year 1933, and that there was probable cause for action in collecting the sum;

It is Further Ordered by the Court that no execution issue to enforce this judgment, but this judgment shall be, and considered, a certificate of probable cause in favor of said Collector, and this judgement shall be paid by the United States of America in due course as provided by law.

23 To this judgment, both parties excepted in open Court and had their exceptions noted of record.

(Signed) WM. H. ATWELL,
United States District Judge.

In United States District Court

Opinion of the court delivered June 11, 1936

Filed June 17, 1936

J. J. Perkins and wife sue to recover certain income taxes for the year 1933. The first recovery is sought on payments made on what is known as the Ozier ranch deal. There were approximately fifty-four hundred acres of land purchased by the plaintiff, for $10,000.00. He claims that it was bought because of its mineral value, and that the surface was practically valueless. By 1933 he had transferred all of his mineral interests so that from that source he had realized approximately $45.00 per acre. In 1936 he sold the surface for $3.75 per acre. The testimony supports his contention that the venture was attractive because of potential mineral value. Gas and oil were being discovered and were being produced in close proximity. The surface of the land was so rough that it had little value for even ranch purposes. When a transaction in respect to which a loss is claimed, is closed and completed by some identifiable event, then such loss is deductible. Generally this occurs when the property is sold or otherwise disposed of. Coolinga Mohawk Oil Co. v. Commissioner, 64 F. (2) 262. But when a property is of mineral nature and purchased because of that attraction, the bookkeeping need not await the final disposition of the fee provided the testimony is sufficient to show the completion of the mineral transaction. In this case the profits from the mineral part
24 of the land, which motivated the deal, were clearly ascertainable in the year 1933, and the taxpayer was not bounden to wait until the year 1936, when he sold the surface right in order to have a recoupment for his capital investment.

The testimony further shows that a figure of three-quarters for the mineral and one quarter for the surface, is quite generous on the part of the plaintiff.

The second transaction centers around the purchase of oil and gas leases in Gregg County in 1929. $105,000.00 in cash were paid, a note for $50,000.00 was given, which has since been settled, and $395,000.00 more were to be paid out of the oil produced and saved. The contract of sale had these provisions:

"Now, therefore, in consideration of the sum of ten dollars ($10.00) cash in hand paid by Faith Oil Corporation, a Texas corporation, and of the further sum of Three Hundred Ninety-five Thousand Dollars ($395,000.00) to be paid out of the oil produced and saved from the hereinafter described lands, and to be one fourth of all the oil produced and saved from the premises hereinafter described until the full sum of three hundred ninety five thousand dollars ($395,000.00) is paid, we, the said Mamie S. Hammonds, joined by her husband, O. O. Hammonds, and Fred P. Branson,

all of Oklahoma City, Oklahoma County, Oklahoma, the present owners of said leases hereinafter described and all rights thereunder and incident thereto, do hereby bargain, sell, transfer, assign, and convey all our right, title, and interest in and to said leases and rights thereunder, hereinafter described, except the five acres specially excepted therefrom, to Faith Oil Corporation, its successors and assigns, to-wit:"

There follows a detailed description of the oil and gas leases
25 and lands covered thereby which are not material to the question involved. The instrument further provided as follows:

"As hereinbefore stated, three hundred ninety five thousand dollars ($395,000.00) is to be paid to Mamie S. Hammonds and Fred P. Branson, each to receive one half thereof out of the oil produced and saved from said leased premises, which payments shall be made by the pipe line company or other purchaser of said oil, and shall be one fourth (¼) of all the oil produced and saved from the above described land until the full sum of three hundred ninety five thousand dollars ($395,000.00) is fully paid, which oil payments shall be made direct to the said Mamie S. Hammonds and Fred P. Branson, or their heirs and assigns, one half to each, by the purchaser or purchasers of said oil, when and as the same is run. It is understood and agreed that the said three hundred ninety-five thousand dollars ($395,000.00) is payable out of oil only, if, as and when produced from said lands above described, and said oil payment does not constitute and shall not be a personal obligation of the assignee its successors or assigns, nor impose any implied obligation with respect to drilling or development except in contract of June 30, 1931, the intention being that said three hundred ninety five thousand dollars ($395,000.00) shall be paid only out of and to the extent of the proceeds of one fourth of the oil produced and saved from said premises, if, as and when produced.

"It is further agreed and understood that the oil payment herein specified shall bear none of the expenses of the development of said leases or any other burden."

At the time of the making of the leases to the plaintiffs, there were no producing wells. Now there are twenty-two on the Burnett,
26 eight on the Fuller, and eight on the Fenton. Approximately one-half of the $395,000.00 oil payment had been paid up to March 13, 1936, and the balance will probably be paid within two and a half years, if production continues.

There is another tract in Upshur County, which was to be paid for by $45,000.00 in oil, but because of the Court's view with reference to the case it need not concern us.

The plaintiffs were required to include as a part of their income the amount which they derived from the operation of the oil properties, and which they paid to their assignors under the assignment

above quoted. They sue for such amounts. They were allowed depletion.

A case almost directly in point against the plaintiffs' contention is Homer Oil Company v. Burnett, 64 F. (2) 965, Cr. Ct. Ap. Eight Cr. In that case Palmer v. Bender, 287 U. S. 553, is cited.

Counsel for the plaintiffs claim that Palmer v. Bender does not support the view taken in that case, and also calls attention to Commissioner v. Flemming, 82 F. (2) 325, Fifth Circuit.

Palmer v. Bender uses the phrase "economic interest." Economic interest has always been considered, but we have not looked at it in exactly the form presented in the Flemming case. We have thought of it as an equitable interest—a mortgagee's interest. Some kind of unmeasured but clearly defined equity which may be asserted if and when the buyer proves recreant. The phrase appears in a depletion case.

Commissioner v. Flemming is also a depletion case. Neither Palmer v. Bender nor Commissioner v. Flemming deals with the obligation of the purchaser, except inferentially. In Commissioner v. Flemming this language is used:

"While the contract was phrased as though the lease and all
27 of the oil were sold, and as though the proceeds were to be paid back to the seller, the real essence of the contract was that the lease was sold and all the oil Except that whose proceeds were to come to the selling taxpayer. The conveyances executed when the cash was paid might very appropriately have reserved or excepted sufficient oil from one half of that thereafter run, to pay the agreed sum. It is true that no royalty to continue indefinitely was reserved, and that the reservation was limited, not to so many barrels, nor to such a length of time, but to so much oil as would sell for the agreed sum. But it was in effect an exception or reservation of oil. The thing sold for the cash consideration was the lease and all of the oil except that so reserved. If the wells had been agreed to be operated before conveyance, until the sellers should receive this oil payment, it is evident that the depletion allowance would apply to his income from the oil. The source of the income and the seller's economic interest in the production of the oil was exactly the same under the agreement that was made. He is equally entitled to the depletion allowance. The purchaser could in no justice claim it as a deduction from his income."

In Pugh v. Commissioner, Judge Sibley, again writing, 49 F. (2) 76, held that the transfer in that case was a sale, as it showed itself to be.

"We construe this to be a conveyance, operative from its date, of a half interest in the royalty right for a total consideration of $250,000.00, $50,000.00 being paid in cash and the special arrangement being made for the payment of the remainder. The arrangement did not involve Eastham in personal liability, but appropriated

the proceeds of his royalty oil to the payment of Pugh, the seller, until $200,000.00 should be paid. It is specially referred to, as the half belonging to Eastham. As the oil was produced, that due to this half of the royalty right was Eastham's oil. The
28 risk of market price was his. When the proceeds were paid over to Pugh, they were paid, not because the oil was Pugh's, but because it was pledged to Pugh. The money went to discharge the price due on Eastham's purchase, and to pay for the right which he had bought."

It will be noted that neither Perkins, the purchaser, nor the purchasers in either the Pugh or the Flemming cases, assume any personal liability. They are identical, so far as that part of the trade is concerned. Flemming and Pugh were royalty holders and were granted relief from income on the ground that what they thought sold, was really not sold. Perkins, in the present case, the purchaser, not the royalty owner, claims relief on the ground that even though he did buy it, the soul of the transaction shows that the seller did not sell that quarter of the oil out of which he, the seller, was to be paid, to Perkins.

I do not see what right this Court has to construe a plain contract between citizens, which does not need any construing, and then say that it does not mean exactly what it says. The contract between Perkins and those who sold to him, provides that "The present owners * * *, do hereby bargain, sell, transfer, assign, and convey all of our rights, title, and interest in and to said leases and rights thereunder * * *." Again, "It is understood and agreed that said $395,000.00 is payable out of oil only, if as and when produced from said lands above described, and said oil payment does not constitute and shall not be a personal obligation of the assignee, its successors or assigns, nor impose any implied obligations with respect to drilling * * *, the intention being that said $395,000.00 shall be paid only out of and to the extent of the proceeds of one-fourth of the oil produced and saved from said premises, if and when produced."

Certainly the seller has an economic interest in the one-
29 fourth. The taking out of the one-fourth depleted the reservoir from which was to come the oil that would pay him. It also depleted the reservoir that Perkins had bought; therefore, each was allowed depletion. But when payments out of that reservoir were made on what Perkins had promised to pay for it, it was income, so far as he was concerned. If it is not his property, then he could never pay the debt with it. He would merely be handing over to the seller what was already the seller's. It seems to me that Perkins bought that oil. He paid a large part of the purchase price in cash. The remainder he was to pay out of the oil as it was produced. If there was not enough oil to pay the entire unpaid portion, then he owed nothing more. It was oil that was bought and sold. The amount of the oil so bought and sold was unknown.

Quite true the seller has an economic interest in it, in the sense that he will be protected and will be able to follow that oil wherever he can find it. He may reduce it, or, its proceeds to possession. It is subject to his process. Because of his equity in it, his economic interest must be satisfied. In order to hold otherwise, we must disregard all of our basic learning. We find ourselves at a loss to find any harmony in the thought that a seller sells and yet he does not sell. When citizens contract for a purchase and sale and then find the Court construing their contract of purchase and sale to mean something else, when upon its face it is perfectly clear, it is confusing.

If we view the title to the oil as vesting in the buyer, subject to the rights of the seller, we escape such confusion. A recent case by the Circuit Court of Appeals for this Circuit is helpful. Standley v. Graham Production Company, decided May 7, 1936. Judge Foster stated that the assignment did not create an estate in the land, but only a lien on the oil after it had been separated from the soil.

Perhaps a Court should never be concerned with economic result of a holding, but a Court cannot close its eyes to the far-reaching effect of a decision which would make a purchaser unconcerned, so far as his income tax return is viewed, by the amount that he is able to pay the one from whom he buys. Literally hundreds of millions of dollars that have been paid for oil leases and oil lands in Texas, to the sellers thereof, would be swept aside as income, and, for which accounting has been made to the government, if we intimate that because a seller has an economic interest in what he conveys to his buyer, on credit, that therefore, the buyer should be allowed to set aside the explicit words of purchase and say that he really only bought that portion of the property which was evidenced by such returns as he did not have to pay on the purchase price. Such a thought is revolutionary in the field of contracts and a serious attack upon the legal definition of income.

A judgment may be prepared for the plaintiffs, giving them a recovery on the Ozier ranch mineral transaction, and against the plaintiffs on their contention as to oil income.

(Signed) WM. H. ATWELL,
United States District Judge.

At Dallas, Texas, June 11, 1936.

In United States District Court

Motion for extension of term of court

Filed June 30, 1936

Come now the plaintiffs, J. J. Perkins and wife, Mrs. Lois Perkins, by and through their attorney of record, and move the Court that

the present term of this Court be continued as to this cause for a period of seventy-five (75) days so that the plaintiffs may pre-
31 pare and have settled such statement of evidence, bill of exceptions and other matters as the plaintiffs may deem necessary and proper.

(Signed) WEEKS & MORROW,
HARRY C. WEEKS,
Attorneys for Plaintiffs.

Staley Building, Wichita Falls, Texas.

In United States District Court

Order granting extension of term of court

Filed June 30, 1936

On this the 30 day of June, A. D. 1936, came on to be heard the motion of plaintiffs that the present term of the Court be continued, as to this cause, for a period of seventy-five (75) days; and the same having been considered by the Court, it is hereby ordered and decreed that the present term of this Court be, and the same is hereby, continued and extended, as to this cause, for seventy-five days from and after this date, so that the plaintiffs may prepare and have settled such statement of evidence, bill of exceptions, and other matters as the plaintiffs may deem necessary and proper.

(Signed) WM. H. ATWELL,
United States District Judge.

In United States District Court

Bill of exceptions

Filed July 7, 1936

Be It Remembered that on the trial of this cause on June
32 11, 1936, the Honorable William Hawley Atwell, United States District Judge, presided, and both parties appeared by counsel. A jury was waived in writing and the following proceedings were had:

I

Both parties presented their pleadings to the Court.

II

By agreement with defendant, the plaintiffs introduced in evidence the evidence heard at the previous trial of this cause, which evidence is as follows:

J. J. PERKINS, being first duly sworn, examined in chief by Mr. Weeks, testified as follows:

My name is J. J. Perkins. I am one of the plaintiffs in this case, my wife is the other plaintiff. I live in Wichita Falls. I have been married sixteen or eighteen years. I am in the oil producing business, more than any other business, and have been about twenty years. I have been active in that business during that time. The major portion of my time has been devoted to producing oil and purchasing oil properties, oil royalties. I give my oil business my personal attention, and have been doing so continuously since I started in that business. I am familiar with the trade practices and customs in the oil business in Texas.

In 1931 I became interested in some oil properties in East Texas, with W. J. Green and the Faith Oil Corporation. Some properties were bought from Branson and Hammonds, and the purchase was made in the name of the Faith Oil Company and was one-
33 fourth for the Faith Oil Company, one-half of the other three-fourths for me, and the other half for W. J. Green, subject to such advances as he might owe. The Faith Oil Corporation, was incorporated, and Mr. Green and I were stockholders in it; Mr. Green was president and I was not an officer or director at that time, but one of the largest stockholders.

There was quite a substantial acreage involved in the purchase from Branson and Hammonds, but only about two hundred and fifty acres in the main portion of the field. The property was not producing at the time we acquired it from Branson and Hammonds. This is a copy of the instrument by which we acquired the property from them.

Mr. WEEKS. We offer the instrument in evidence.

Plaintiff's Exhibit No. 1

THE STATE OF TEXAS,
County of Gregg.

Whereas, Mamie S. Hammonds and Fred P. Branson are the owners of certain oil and gas leases in Gregg and Upshur Counties, Texas, on the lands hereinafter described, and are owners of all rights thereunder or incident thereto.

Now, Therefore, in consideration of the sum of Ten Dollars ($10.00), cash in hand, paid by Faith Oil Corporation, a Texas Corporation, and of the further sum of Three Hundred Ninety Five Thousand Dollars ($395,000.00) to be paid out of the oil produced and saved from the hereinafter described lands, and to be one-fourth of all the oil produced and saved from the premises hereinafter described, until the full sum of Three Hundred and Ninety Five
34 Thousand Dollars ($395,000.00) is paid, we, the said Mamie S. Hammonds, joined by her husband, O. O. Hammonds, and Fred P. Brandon, all of Oklahoma City, Oklahoma County, Okla-

homa, the present owners of said leases hereinafter described and all rights thereunder and incident thereto, do hereby bargain, sell, transfer, assign, and convey all our rights, title, and interest in and to said leases and rights thereunder, hereinafter described, except the five acres specially excepted therefrom, to Faith Oil Corporation, its successors and assigns, to-wit:

"Detailed descriptions of oil and gas leases omitted in printing because the same are immaterial to any issue. The instrument assigned oil and gas leases made by the following original lessor: D. W. McQueen and wife; J. J. Fuller and wife; E. E. Stone and Wife; J. C. Barrett, B. B. Fenton; Mrs. Lucille Thrasher et al.; J. M. Hamby and wife", as per stipulation of counsel copied at page one hereof.

* * * * * * *

As hereinbfore stated, Three Hundred Ninety Five Thousand Dollars ($395,000.00) is to be paid to Mamie S. Hammonds and Fred P. Branson, each to receive one-half thereof, out of the oil produced and saved from said leased premises, which payments shall be made by the pipe line company or other purchaser of said oil, and shall be one-fourth (¼) of all the oil produced and saved from the above described land, until the full sum of Three Hundred Ninety Five Thousand Dollars ($395,000.00) is fully paid, which oil payments shall be made direct to the same Mamie S. Hammonds and Fred P. Branson, or their heirs and assigns, one-half to each, by the purchaser or purchasers of said oil, when and as the same is run. It is understood and agreed that the said Three Hundred Ninety-
35 five Thousand Dollars ($395,000.00) is payable out of oil only, if, as and when produced from said lands above described, and said oil payment does not constitute and shall not be a personal obligation of the assignee, its successors or assigns, nor impose any implied obligation with respect to drilling or development, except in contract of June 30, 1931, the intention being that said Three Hundred Ninety-five Thousand Dollars ($395,000.00) shall be paid only out of and to the extent of the proceeds of one fourth of the oil produced and saved from said premises, if, as and when produced.

It is further agreed and understood that the oil payment herein specified shall bear none of the expenses of the development of said leases or any other burden.

And for the same consideration, the said Mamie S. Hammonds, joined by her husband, O. O. Hammonds and Fred P. Branson, and their heirs and legal representatives, covenant with the said Faith Oil Corporation, its successors and assigns, that they are the lawful owners of said leases and interest thereunder, and of the personal property thereon or used in connection therewith; that they have good right and authority to sell and convey the same, and that said rights, interest, and property are free and clear from all liens and encumbrances, and that all rentals and royalties due and payable thereunder have been duly paid, and that they do hereby warrant

and agree to defend the title to said leasehold estate in the lands above described against the lawful claims and demands of all persons, whomsoever.

In Witness Whereof, the said Mamie S. Hammonds, O. O. Hammonds and Fred P. Branson, have signed this instrument, this the 24 day of July, A. D. 1931.

(Signed) MAMIE S. HAMMONDS.
O. O. HAMMONDS.
FRED P. BRANSON.

36 "Acknowledgments and recording data omitted because immaterial," as per stipulation of counsel copied at page one hereof.

* * * * * * *

Mr. WEEKS: For the purpose of showing the nature of the interest of Branson and Hammonds, we offer in evidence Plaintiff's Exhibits 2, 3, and 4, as follows:

Plaintiff's Exhibit 2

Oil and Gas Lease

Agreement, made and entered into the 29th day of July 1930, by and between B. B. Fenton and Wife, Myra Fenton, of Gregg County, Texas, hereinafter called lessor (Whether one or more), and J. A. Reynolds, hereinafter called lessee:

Witnesseth: That the said lessor, for and in consideration of One Dollars cash in hand paid, receipt of which is hereby acknowledged, and of the covenants and agreements hereinafter contained on the part of lessee to be paid, kept and performed, has granted, demised, leased, and let and by these presents does grant, demise, lease and let unto the said lessee, for the sole and only purpose of mining and operating for oil and gas, and laying pipe lines, and building tanks, power stations, and structures thereon to produce, save, and take care of said products, all that certain tract of land situated in the County of Gregg, State of Texas, described as follows, to-wit: All that certain tract, lot or parcel of land situated in Gregg County,

37 Texas, about 9½ miles from Longview, a part of M. Irwin H. R. Survey No. 19, beginning at R. P. Doby's N. W. Corner on the Irwin Line a stake for Corner from which a Pine brs. N. 78½ E. 2.6 vrs. Thence N. 498 vrs. to said Irwin's N. W. Corner a stake from which a Red Oak Brs. S. 20 E. 13.6 vrs. Thence E. 566.8 vrs. a stake for corner from which a Post Oak brs. S. 57 W. 92 vrs. A Hickory brs. N. 27 E. 12 vrs. Thence 498 vrs. to N. W. Corner of Pleas Doby's 50 acre tract, and N. W. Corner J. H. Satterwhites 14 acre tract. Thence W. 566.8 vrs., to place of beginning, containing 50 acres, declination of the Needle 8½ Degrees. Recorded in Book 54, Page 47. Being all the land I own in Gregg County, and containing 50 acres, more or less.

It is understood that this lease shall remain in force for a term of 5 years from date, and as long thereafter as oil or gas, or either of them, is produced from said land by the lessee.

In consideration of the premises the said lessee covenants and agrees:

1st. To deliver to the credit of lessor, free of cost, in the pipe line to which lessee may connect his wells, the equal one-eighth part of all oil produced and saved from the leased premises.

2nd. To pay to lessor, as royalty for gas from each well where gas only is found, while the same is being sold or used off of the premises, one-eighth of the market price at the wells of the amount so sold or used, the lessor to have gas free of charge from any gas well on the leased premises for all stoves and inside lights in the principal dwelling house on said land by making lessor's own connections with the well at lessor's own risk and expense.

3rd. To pay to lessor as royalty for gas produced from any
38 oil well and used by lessee for the manufacture of gasoline, one-eighth of the market value of such gas. If such gas is sold by lessee, then lessee agrees to pay lessor, as royalty, one-eighth of the market price at the wells of the amount sold.

If no well be commenced on said land on or before the 1st day of Dec. 1930, this lease shall terminate as to both parties, unless the lessee on or before that date shall pay or tender to the lessor, or to the lessor's credit in the 1st National Bank at Longview, Texas, or its successors, which shall continue as the depository regardless of changes in the ownership of said land, the sum of $50 Dollars, which shall operate as a rental and cover the privilege of deferring the commencement of a well for 12 months from said date. In like manner and upon like payments or tenders the commencement of a well may be further deferred for like periods of the same number of months successively. And it is understood and agreed that the consideration first recited herein, the down payment, covers not only the privilege granted to the date when said rental is payable as aforesaid, but also the lessee's option of extending that period as aforesaid and any and all other rights conferred.

Should the first well drilled on the above described land be a dry hole, then, and in that event, if a second well is not commenced on said land within twelve months from the expiration of the last rental period, which rental has been paid, this lease shall terminate as to both parties, unless the lessee on or before the expiration of said twelve months shall resume the payment of rentals in the same amount and in the same manner as hereinbefore provided. And it is agreed that upon the resumption of the payment of rentals, as above provided, that the last preceding paragraph hereof, governing the payment of rentals and the effect thereof, shall continue in force just as though there had been no interruption in the rental payments.

If, at the expiration of 5 years from the date of this lease, oil or gas is not being produced on the leased premises, but lessee is then engaged in drilling for oil or gas, then this lease shall continue in force so long as drilling operations are being continuously prosecuted on the leased premises; and drilling operations shall be considered to be continuously prosecuted if not more than sixty (60) days shall elapse between the completion or abandonment of one well and the beginning of operations for the drilling of a subsequent well. If oil or gas shall be discovered and produced in paying quantities from any such well or wells drilled at or after the lapse of 5 years, this lease shall continue in force so long as oil or gas shall be produced from the leased premises.

It is specially agreed that in the event that oil or gas is produced from said premises and said production shall for any reason cease or terminate, lessee shall have the right at any time within ninety (90) days from the cessation of such production to resume drilling operations in the effort to make said leased premises again produce oil or gas, in which event this lease shall remain in force so long as such operations are continuously prosecuted, as defined in the preceding paragraph, and if they result in production of oil or gas, so long thereafter as oil or gas is produced in paying quantities from the premises.

If said lessor owns a less interest in the above described land than the entire and undivided fee simple estate therein, then the royalties and rentals herein provided for shall be paid the said lessor only in proportion which lessor's interest bears to the whole and undivided fee.

Lessee shall have the right to use, free of cost, gas, oil, and water produced on said land for all operations thereon, except from water wells of lessor. When requested by lessor, lessee shall bury its pipe line below plow depth. No well shall be drilled nearer than 200 feet to the house or barn now on said premises without the written content of the lessor. Lessee shall pay for damages caused by all operations to growing crops on said land. Lessee shall have the right at any time to remove all machinery and fixtures placed on said premises, including the right to draw and remove casing.

If the estate of either party hereto is assigned, and the privilege of assigning in whole or in part is expressly allowed, the convenants hereof shall extend to their heirs, executors, administrators, successors or assigns, but no change in the ownership of the land or assignment of rentals or royalties shall be binding on the lessee until after the lessee has been furnished with a written transfer or assignment or a true copy thereof, and it is hereby agreed in the event this lease shall be assigned as to a part or parts of the above described lands and the assignee or assignees of such part or parts shall fail or make default in the payment of the proportionate part

of the rents due from him or them, such default shall not operate to defeat or affect this lease in so far as it covers a part or parts of said lands upon which the said lessee or any assignee thereof shall make due payment of said rental.

Lessee shall have the exclusive right to build, operate, and maintain pits, reservoirs, pickup stations, and plants for the purpose of picking up and conserving the waste oil that flows down the creeks, ravines, and across the land embraced in this lease whether said oil is produced from lands covered by this lease or other lands and lessor shall be entitled to receive the royalty hereinbefore reserved on all such oil so saved.

In case of cancellation or termination of this lease for any
41 cause, lessee shall have the right to retain under the terms hereof twenty (20) acres of land around each oil or gas well producing, being worked on, or drilling hereunder (as long as such operations are continued in good faith) such tract to be designated by lessee in as near as a square form as practicable.

In the event lessor considers that lessee has not complied with all its obligations hereunder, both express and implied, before production has been secured or after production has been secured, lessor shall notify lessee in writing, setting out specifically in what respects lessee has breached this contract. Lessee shall then have sixty (60) days after receipt of said notice within which to meet or commence to meet all or any part of the breaches alleged by lessor. The service of said notice shall be precedent to the bringing of any action by lessor on said lease for any cause, and no such action shall be brought until the lapse of sixty (60) days after service of such notice on lessee. Neither the service of said notice nor the doing of any acts by lessee aimed to meet all or any of the alleged breaches shall be deemed an admission or presumption that lessee has failed to perform all its obligation hereunder.

Title to the minerals vested in grantee under this grant shall not end or revert to grantor until there is a complete, absolute, and intentional abandonment by grantee of each and all of the purposes expressed or implied, of this grant and every part and parcel of the premises described in this grant.

Lessor hereby warrants and agrees to defend the title to the lands herein described, and agrees that the lessee shall have the right at any time to redeem for lessor by payment, any mort-
42 gage, taxes, or other liens on the above described lands, in the event of default of payment by lessor, and be subrogated to the rights of the holder thereof, and lessor hereby agrees that any such payment made by the lessee for the lessor shall be deducted from any amounts of money which may become due the lessor under the terms of this lease.

In Testimony Whereof, we sign, this the 29th day of July 193—.

(Signed) B. B. FENTON,
MYRA FENTON.

"Acknowledgments and recording data omitted because immaterial", as per stipulation of counsel copied at page one hereof.

* * * * * * *

Plaintiff's Exhibit 3

"This Exhibit was an oil and gas lease from J. C. Barrett to J. A. Reynolds, dated August 26, 1929, and, except as to parties and descriptions, is identical with Exhibit 2 and is therefore omitted", as per stipulation of counsel copied at page one hereof.

* * * * * * *

Plaintiff's Exhibit 4

Oil and Gas Lease.

"This Exhibit was an oil and gas lease from J. J. Fuller and wife to Mamie S. Hammonds, dated September 22, 1930, and, except for parties and descriptions, is identical with Plaintiff's Exhibit 2, and is therefore omitted in printing" as per stipulation of counsel copied at page one hereof.

* * * * * * *

43 The WITNESS. This assignment, Plaintiff's Exhibit 1, dated July 24, 1931, was originally in the name of the Faith Oil Corporation, and Mr. Green and I were interested with that corporation to the extent of three-fourths. This instrument recited a consideration of $10.00 in addition to this oil payment, but that was not the consideration; the consideration was $105,000.00 in cash and some notes for $50,000.00, which were later paid, making a total of $155,000.00. The Green-Perkins interest, which stood in the name of the Faith Oil Corporation, were later assigned to me. This is a copy of the assignment; there were two such assignments, both of these are copies of the original.

Mr. WEEKS. We offer in evidence the assignments placing the record title to Perkins and Green interest, which had been in the name of the Faith Oil Corporation, in the name of Mr. Perkins. We offer the instruments in evidence as Plaintiff's Exhibit 5–a and 5–b, as follows:

Plaintiff's Exhibit 5–a

STATE OF TEXAS, *County of Gregg:*

Whereas Faith Oil Corporation holds in its own name the record title to the hereinafter described oil and gas leases situated in Gregg and Upshur Counties, Texas, as hereinafter set out, while the real ownership of said leases is owned three-fourths (¾) by J. J. Perkins, and one-fourth (¼) by said Faith Oil Corporation and all rights thereunder or incident thereto in connection with said oil and gas lease.

Now, Therefore, in consideration of the sum of Ten Dollars
44 ($10.00) cash in hand paid by J. J. Perkins to Faith Oil Corporation, a Texas Corporation, the receipt of which is hereby acknowledged and for the purpose of vesting the record title of said leases according to their actual ownership the said Faith Oil Corporation, acting by and through its duly authorized President, W. J. Green, does hereby bargain, sell, transfer, assign and convey unto the said J. J. Perkins an undivided three-fourths (¾) interest in and to said oil and gas leases and all rights thereunder, as hereinafter set out (the said Faith Oil Corporation retaining an undivided one-fourth (¼) interest in and to said oil and gas leases); there having been executed an assignment of certain oil and gas leases dated July 24, 1931, and filed in the Gregg County Deed Records on July 28, 1931, at 1:10 P. M., and recorded in Volume —, Page —, Gregg County Deed Records, File No. 21719, from Mamie S. Hammonds and husband, O. O. Hammonds, and Fred P. Branson to Faith Oil Corporation and reference is here made to said assignment for a better description of the lands covered by said oil and gas leases in and to which an undivided three-fourths (¾) interest is hereby conveyed by said Faith Oil Corporation to J. J. Perkins, which leases are described as follows, to-wit:

First: An oil and gas lease from D. W. McQueen and wife covering a part of the H. F. Rogers, James Price, and Dan Meredith H. R. Surveys containing 192 acres of land, more or less, and being described in a deed of Trust to Federal Land Bank, as shown in Volume 11, page 131, Deeds of Trust Records of Gregg County, Texas, with the exception of 60 acres leased out of said above described land.

Second: An oil and gas lease executed by E. E. Stone and wife, Blanche Stone, covering 51.7 acres more or less out of H. H. Kirk Headright Survey about 8 miles north of Longview, Texas.

45 Third: An oil and gas lease executed by J. C. Barrett covering all of the B. W. Witcher Headright Survey situated about 10 miles north of Longview, Texas, except the north 100 acres of said Witcher Survey, and except 80 acres assigned by Mamie S. Hammonds, et vir, to Shell Petroleum Corporation, dated January 10, 1931.

Fourth: An oil and gas lease executed by Mrs. Lucile Thrasher et al., and recorded in Book 4, Page 549-551, Gregg County Deed Records covering 55½ acres of land out of H. H. Kirk Headright Survey.

Fifth: An oil and gas lease executed by J. M. Hamby and wife and recorded in Book 59, Page 622, Gregg County Deed Records and covering 320 acres more or less out of the John Lout Headright Survey in Gregg County, Texas, and also 50 acres of land more or less out of the Chas. P. Hereford Headright Survey and recorded in Volume X, page 246, Gregg County Deed Records.

In said assignment made by Mamie S. Hammonds et al. to Faith Oil Corporation there was retained in said conveyance an oil payment to the extent of $395,000.00 to be paid out of one-fourth of all the oil produced and saved from the lands described in said assignment and this conveyance is made by Faith Oil Corporation to J. J. Perkins subject to said oil payment, as is fully set out in said assignment above mentioned.

(The object and intention of this conveyance is not to increase or to decrease in any way the burdens upon said leases, or any one of them, but to vest in said J. J. Perkins an undivided three-fourths (¾) interest in said leases and retain in the Grantor herein
46 an undivided one-fourth (¼) interest in said leases subject to said oil payment); and for the same consideration the said Faith Oil Corporation, its successors and assigns covenant and agree with the said J. J. Perkins, his heirs and assigns, that it is the lawful owner of said leases and interest thereunder and the personal property thereon, or used in connection therewith and that it has good right and authority to sell and convey the same and that said rights, interests, and property are free and clear of any liens and incumbrances except as shown by the Gregg County Deed Records and that all rentals and royalties due and payable thereunder have been duly paid and it does hereby warrant and agree to protect the title to said leasehold estate and the lands above described against the lawful claims and demands of any person whomsoever to the extent of the interest hereby conveyed.

In Testimony Whereof Witness its name and corporate seal on this the 4th day of June, A. D. 1932.

FAITH OIL CORPORATION,
By W. J. GREEN, *President.*

Attest:
[SEAL]

JOHN C. COFFEY,
Secretary.

"Acknowledgments and recording data omitted because immaterial", as per stipulation of counsel copied at page one hereof.

* * * * * * *

Plaintiff's Exhibit 5-b

THE STATE OF TEXAS,
County of Gregg.

Whereas, Mamie S. Hammonds and husband, O. O. Hammonds, and Fred P. Branson of Oklahoma City, Oklahoma,
47 did on or about July 24, 1931, transfer, assign, and convey unto Faith Oil Corporation certain oil and gas leases situated in Gregg County, Texas, reference being made to said recorded instruments for the description of the properties covered thereby and the terms of said conveyance, and did in said assignment convey

what is known as the J. J. Fuller lease, which is recorded in Book 5, Page 381, which is described as follows:

All that certain lot, tract, or parcel of land being situated in Gregg County, Texas, about 8½ miles N. W. from the town of Longview and being a part of the M. A. Alexander H. R. Survey; Beginning at the N. E. corner of the old Wm. Fuller tract, a stake from which a black jack brs. S. 8½ E. 7 vrs.; thence S. 359 vrs. to a stake from which a double red oak brs. S. 50 E. 7 vrs.; thence in a westernly direction with an old cross fence 372 vrs. to a stake from which a small red oak brs. N. 26 E. 2 vrs. a Post Oak brs. E. 2 vrs.; thence S. 75 W. 20 vrs., a stake from which a Black Jack brs. N. 76 W. 7 vrs.; thence S 23 vrs. W. 123 vrs. a stake from which a Red Oak brs. S. 84 W. 9 vrs.; thence S. 56 W. 343 vrs. a stake from which a red Oak brs. N. 55 W. 8 vrs.; thence N. 81 W. 116 vrs. a stake from which a Post Oak brs. N. 30 W. 18 vrs.; thence S. 22 W. 125 vrs. to a stake; thence N. 70 W. 30 vrs. a stake from which a walnut brs. N. 4 W. 2 vrs.; thence S. 20 W. 50 vrs. a stake from which a black jack brs. S. 78 W. 8 vrs.; thence S. 45 W. 66 vrs to a stake in the E. B. Line of Maury Irwin Survey a pipe brs. S. 58 E. 3 vrs.; thence N. with Irwin's E. B. line 620 vrs. to the N. W. corner of the Wm. Fuller home tract a stake near the root of a fallen tree; thence E. 750 vrs. to place of beginning containing in all 56 4/10 acres of land more or less. But from this lease is excepted approximately 5 acres in the S. W. corner thereof.

48 Said lease is duly recorded in Book 4, Pages 211 to 212, Oil & Gas Lease Records of Gregg County, Texas.

And, also, an assignment of oil and gas lease executed by B. B. Fenton which lease is recorded in Vol. 59, Page 610, Gregg County Deed Records, which land is described as follows, to-wit:

All that certain tract, lot or parcel of land situated in Gregg County, Texas, about 9½ miles from Longview a part of M. Irwin H. R. Survey No. 19; Beginning at R. P. Doby's N. W. corner on the Irwin Line, a stake for corner from which a pine brs. N. 78½ E. 2.6 vrs.; thence N. 498 vrs. to said Irwin N. W. corner a stake from which a read oak brs. S. 20 E. 13.6 vrs.; thence E. 566.8 vrs. a stake for corner from which a post oak brs. S. 57 W. 92 vrs. a hickory brs. N. 27 E. 12 vrs.; thence 498 vrs. a N. W. corner of Pleas Doby's 50 acre tract and N. W. corner of J. H. Satterwhite's 14 acre tract; thence W. 566.8 yrs. to place of beginning containing 50 acres; declination of the Needle 8½ deg. Recorded in Book 54, Page 47, which assignment covers other lands as well but which are not under consideration at this time, and

Whereas, J. J. Perkins is the owner of an undivided three-fourths (¾) interest in and to said two above described leases, though as a matter of convenience the record title has been in the Faith Oil Corporation and it is the desire of Faith Oil Corporation and J. J. Perkins that a instrument be executed placing the record title to

J. J. Perkins' undivided three-fourths (¾) interest in and to said leases in him so that the records may disclose the true ownership.

Now, therefore, for and in consideration of Ten Dollars
49 and other good and valuable considerations, the receipt of which is hereby acknowledged, and for the purpose of setting out the actual ownership in said property, the said Faith Oil Corporation does hereby bargain, sell, transfer, assign, and convey unto the said J. J. Perkins of Wichita County, Texas, an undivided three-fourths (¾) interest in and to said above described two leases known as the J. J. Fuller lease and the B. B. Fenton lease and hereinbefore described by metes and bounds, together with all personal property used or obtained in connection therewith to J. J. Perkins, his heirs and assigns, and for the same consideration the said Faith Oil Corporation for itself, its successors and assigns does covenant with the said J. J. Perkins, his heirs and assigns that it is the lawful owner of said leases and all rights and interest thereunder and of the personal property thereon or used in connection therewith; that it has good right and authority to convey the same and that it will warrant and forever defend the same against the lawful claim and demands of all persons whomsoever.

This conveyance, however, is made subject to the contingent oil payment as contained in the assignment from Mamie S. Hammonds et al., above referred to.

The object and intention of this instrument being to vest title to an undivided three-fourths (¾) interest in and to said above two described leases in J. J. Perkins and retain in the Grantor herein an undivided one-fourth (¼) interest in the two above described leases without in any way increasing or decreasing the burdens and obligations of said properties.

In Testimony Whereof witness its name and seal on this 20th day of June A. D. 1932.

FAITH OIL CORPORATION,
[SEAL] By W. J. GREEN, *President.*
Attest: JOHN C. COFFEY,
Secretary.

50 "Acknowledgments and recording data omitted because immaterial", as per stipulation of counsel copied at page one hereof.

* * * * * * *

The WITNESS. We subsequently developed that property for oil. It was in the fall of 1931 that the first well was drilled on the J. J. Fuller lease, and I think it was about the same time that the first well was drilled on the Fenton lease, and the other was the Barrett lease, of about 154 acres, and the first production on that was in the Spring of 1932. We continued to develop it. We had twenty-two wells on the Barrett lease and eight on the Fuller and eight on the Fenton.

I continued through 1933 to own the interest in the property originally acquired; that is, undivided three-eighths interest.

The oil from each lease was run into a battery of tanks on the respective leases, and division orders executed to the pipe line companies, running that oil, the royalty owners received one eighth, Branson and Hammonds, jointly received one-fourth, and the remaining five-eighths going to the Faith Oil Corporation, Green, and myself. I think during the year 1933 perhaps all the checks for our five-eighths were made payable to the Faith Oil Corporation covering my interest and Green's interest, and the Faith's interest. That was done at all times from the time we began producing through 1933, and up to the present time. That oil payment has not been discharged, but it will be some time before it is paid, if ever.

As to the actual receipt of the money, I will state, there was delivered in the pipe line, to the credit of Branson and Hammonds, one-fourth of the oil produced, and I presume the pipe-line companies paid them, because they never paid us. I think I can say
51 I know it was paid, because I discussed it with Judge Branson and Mrs. Hammonds many times, and they would speak of the payments they had received on this lease. I know that we never received a dollar of those payments. I know that is true in respect to the Faith Oil Corporation and W. J. Green. When I spoke of the division orders that were executed, that is the ordinary and customary way of handling that matter in the oil business. These instruments which you hand me are typical of the division orders which were executed in respect to those properties.

Mr. WEEKS: We offer in evidence those four samples of division orders, being typical of the ones that were made.

(Said instruments marked "Plaintiff's Exhibits 6, 6-a, 6-b, and 6-c", and reading as follows:)

Plaintiff's Exhibit 6

Magnolia Petroleum Company

Transfer Order

JUNE 20, 1932.

To MAGNOLIA PETROLEUM COMPANY,
Dallas, Texas:

The undersigned, having transferred, as indicated below, oil production of wells numbered _____ on the Faith Oil Corporation on the J. J. Perkins far, more particularly described as 56.4 acres out of the M. L. Alexander Survey less 5 acres in the southwest part thereof, in Gregg County, State of Texas, you are here-
52 by authorized, beginning at 7 o'clock A. M. on the _____ day of _____ 19__, and until further notice, to give credit for oil received on account of said interest so transferred as follows:

Credit to—	Transferred interest	P. O. address (give box no. or st. address)
J. J. Fuller	3/64 RI	
Frank Buttram	155/3072 RI	
A. W. Gilliland	1/96 RI	
F. W. C. Loyalty Corp	1/64 RI	
Errett R. Newby	5/3072 RI	
Faith Oil Corp'n	20/32 WI	
Mrs. Mamie S. Hammonds	4/32 WI	
Until $197,500 is paid, reverts to Faith Oil Corporation.		
Fred P. Branson	4/32 WI	
Until $197,000 is paid, reverts to Faith Oil Corporation.		

Witness:

The undersigned certify that they are the legal owners of the interest above transferred and warrant the title thereto, and the Magnolia Petroleum Company is hereby authorized, until further notice, to receive oil for purchase from said parties, subject to the following conditions:

1. Quantities are to be computed from regularly compiled
53 tank tables, the oil owner to have the privilege of witnessing gauge tickets, and, in addition to the deductions of the tank tables, corrections shall be made for temperature and impurities according to your local rules in force at the time, and oil shall be steamed when necessary to render it merchantable.

2. Satisfactory abstracts and other evidence of title will be furnished to you at any time on demand. In the event of a failure to so furnish such evidence of title, or in the event of a dispute at any time concerning title, you may hold the oil run or its proceeds, without interest, until indemnity satisfactory to you has been furnished.

3. Runs to Magnolia Pipe Line Company for your account or to any other pipe line company designated by you, shall be valid delivery, and said pipe line company in your place and stead may make the aforesaid deductions and corrections.

4. In the absence of written agreement to the contrary, oil received under this division order shall become your property when delivered to said pipe line company, and shall be paid for to the party or parties according to the divisions of interests shown above at the price posted by Magnolia Petroleum Company for the same kind and quality of oil in the particular field in which it is received

on the day on which it is received by said pipe line company into its custody. For the amount due on account of the oil received during each calendar month, payment shall be made on or before the 12th day of the next succeeding month by mailing Magnolia Petroleum Company's checks therefor to the addresses of said parties respectively as given above, or by deposit of the sum due to the credit of said parties respectively at_____bank at_____. Except that you are authorized to withhold payment due any individual payee until at least five dollars ($5.00) has accu-
54 mulated to the credit of such payee, it being agreed, however, that regardless of amount so accumulated to the credit of such payee, *it being agreed, however, that regardless of amount so accumulated to the credit of such payee* you will, in December of each year, make payment of the full amount so credited to each payee for oil run up to and including the month of November of such year.

5. You are not expected to receive oil in definite quantities or for fixed periods nor to provide storage on the credit balance plan or otherwise except as and when you shall now or hereafter so agree in writing.

6. Sellers severally agree to notify Magnolia Petroleum Company of any change of ownership; it being understood that any vendee or assignee of said wells or the production thereof shall take same subject to the terms hereof.

FAITH OIL CORPORATION.
MAMIE S. HAMMONDS.
FRED P. BRANSON.

Witness:

Plaintiff's Exhibit

Stanolind Crude Oil Purchasing Company

Division Order

AUGUST 1, 1933.

TO STANOLIND CRUDE OIL PURCHASING COMPANY,
Tulsa, Okla.:

The undersigned, and each of them, guarantee and warrant that they are the legal owners in the proportions set out below of all the oil produced from the _____ J. J. Fuller Farm, described as 56.4 acres out of the M. Alexander Survey less 5 acres in the SW. part thereof, more fully described as follows: Beginning at
55 the NE. cor. of the old Wm. Fuller tract; thence So. 359 vrs., a stake; thence in a westerly direction with an old cross fence 372 vrs., a stake; thence So. 75° W. 20 vrs., a stake; thence so. 23° W. 123 vrs.; thence 56° W. 34 vrs., a stake; thence 81° W. 116 vrs., a stake; thence S. 22° W. 125 vrs.; thence N. 70° W. 30 vrs., a stake; thence 20° W. 50 vrs., a stake; thence S. 45° W. 66 vrs., a stake in the EB. L. of Irwin's Survey; thence N. with EB. L. Irwin Sur. 620 vrs. to NW. cor. of Wm. Fuller home tract; thence E. 760 vrs. to

place of beginning in Gregg County, State of Texas, and commencing at 7 a. m. the 1st day of August 1933, and until further written notice either from you or us; you are authorized to receive oil therefrom, purchase it and pay therefor as follows:

Credit to—Div. of Interest—P. O. Address

The First National Bank, Gilmer, Texas. 7/8 W. I.

Subject to the following oil payments:

(1) $197, 500.00 out of 1/7 or 7/8 WI payable to Mrs. Mamie S. Hammonds, 623 E. 18th St., Oklahoma City, Okla.

(2) $197,500.00 out of 1/7 of 7/8 WI payable to Fred P. Branson, c/o Skirvin Hotel, Oklahoma City.

The 1/8 Royalty Interest:

J. J. Fuller, Route 2, Longview, Texas, 3/8.

Frank Buttram, 2908 First National Bank Bldg., Okla. City, Ok., 155/384.

Errett R. Newby, 2909 First National Bank Bldg., Okla. City, Ok., 5/384.

56 Fidelity Royalty Co., 706 Barniff Bldg., Okla. City, Okla., 1/12.

F. W. C. Royalty Corp., Drawer 1866, Houston, Texas, 1/8.

Faith Oil Corp. agrees to notify Stanolind Crude Oil Purchasing Company in writing when the above mentioned oil payments are completed and will hold Stanolind Crude Oil Purchasing Company harmless for any overpayments on said oil payments in the absence of written notice.

The following covenants are also parts of this division order, and shall be binding upon the undersigned, their successors, legal representatives and assigns:

First: The oil run hereunder shall become your property as soon as the same is received into your custody or that of any pipe line company designated by you.

Second: The oil received and purchased pursuant hereto shall be delivered f. o. b. to any pipe line designated by you which gathers and receives said oil, and you agree to pay for such oil to the respective owners according to the division of interest hereinabove indicated, at the price paid by you for similar crude oil in the field where said oil is produced, preva'ling on the date of each respective run; settlements and payments shall be made monthly account oil runs during the preceding month, by check of Stanolind Crude Oil Purchasing Company mailed from Tulsa, Oklahoma, to the respective parties at the addresses above given. Pipe line grades and measurements shall govern and control in all settlements.

Third: You are to receive merchantable oil only under the

57 terms of this division order. The gauging, testing, and correction for temperature of, and deductions from, oil pur-

chased hereunder, shall be in accordance with the Pipe Line Rules and Regulations of the Railroad Commission of Texas.

Fourth: Satisfactory abstracts, or other evidence of title, will be furnished at any time on demand. In the event of failure to furnish such evidence of title, or in the event of any dispute or question at any time concerning the title to said land and/or the oil produced therefrom, you are authorized to withhold the proceeds of all oil received and run, without interest, until such dispute, defect, or question of title is corrected or removed to your satisfaction, or until indemnity satisfactory to you has been furnished; and in the event any action or suit is filed in any Court affecting the title to the land above described or the oil produced therefrom, to which any of the undersigned is a party, written notice of the filing of such suit or action shall be immediately furnished you by the undersigned, stating the Court in which the same is filed and the title of such suit or action.

Fifth: This division order shall become valid and binding on each and every owner above named as soon as signed by him or her regardless of whether or not any of the other above named owners have so signed; and in consideration of the purchase of oil hereunder, consent is hereby given to you and/or any pipe line company which you may cause to connect with the wells and/or tanks on said land, to disconnect and remove such pipe lines, in case of termination by either you or us of purchases under this division order.

Sixth: The undersigned, and each of them, guarantee and warrant, for your benefit and that of any pipe line or other carrier designated by you to run or transport said oil, that all oil tendered hereunder has been produced in accordance with the laws of Texas and the rules and regulations of the Railroad Commission of Texas.

58

FAITH OIL CORPORATION,
By W. J. GREEN, *President.*
FIRST NAT'L BANK, GILMER, TEXAS,
By H. P. MCGAUGHY, *President.*
F. W. C. ROYALTY CORPORATION,
By A. W. CROSBY, *Vice-President.*
FRED P. BRANSON.
MAMIE S. HAMMONDS.
J. J. PERKINS.

Witnesses:
[SEAL]
S. A. MAN, *Secretary.*
Attest:
L. B. MARTIN, *Cashier.*

Attest:
G. U. WATSON, *Secretary.*

Please insert correct address.

Plaintiff's Exhibit 6-a

OP-150

Simms Oil Company

Division Order

MAY 10TH, 1933.

To SIMMS OIL COMPANY:

The undersigned certify and guarantee that they are the
59 legal owners of wells numbered 1 and upon the Faith Oil Corporation-O. F. Wencker farm more particularly described as 14.15 acres out of the B. W. Witcher Survey, more particularly described by metes and bounds on the reverse side hereof, in Gregg County, State of Texas, including the royalty interest and until further written notice you are authorized for your own account to receive oil therefrom into your possession or the possession of any person or corporation designated by you, giving credit as directed below:

Due to the great number of royalty owners and the small interests it is agreed that Simms Oil Company, at its option, shall not make payment for the runs to the credit of any interest until there has accumulated as much as $5.00, and in any event, payment shall not be made oftener than every three months.

Credit to—	Division of interest	P. O. address
Faith Oil Corporation	⅛ W. I.	c/o J. J. Perkins, Wichita Falls.
Fred P. Branson	⅛ W. I.	c/o Skirvin Hotel, Okla City, Okla.
Mrs. Mami (S. Hammonds	⅛ W. I.	623 E. 18th St., Okla City, Okla.

"Division of royalty interest omitted because immaterial," as per stipulation of counsel copied at page one hereof.

* * * * * * *

Simms Oil Company is hereby authorized until further notice to receive oil from said wells for purchase from the said parties severally the proportions named, subject to the following conditions:

First: That oil run in pursuance of this division order
60 shall become the property of Simms Oil Company as soon as the same is received into the custody of it or its designated agent.

Second: The oil received in pursuance of this division order shall be paid for to the party or parties entitled thereto according to the interest shown above, at the posted price of Sun Oil Company in the field where received, for the same kind and quality of oil on the day of the receipt thereof, payments to be made monthly by checks mailed to said party or parties at their respective addresses above set out.

Third: Oil shall be steamed when necessary to render it merchantable. A deduction of two percent (2%) from the oil received shall be made to cover evaporation, shrinkage, waste or other loss. The oil must be free from sand, dirt, water, emulsion or other sediment, and if found not to be such by the tests then in use by Simms Oil Company, may be rejected or at the option of Simms Oil Company may be accepted and when accepted Simms Oil Company shall be permitted to deduct the full percentage of sand, dirt, water emulsion and/or other sediment found to be contained in the oil. Corrections will be made for temperatures, deducting or allowing on a basis of one per cent (1%) for each 25 degrees Fahrenheit variation above or below 60 degrees Fahrenheit.

Fourth: The undersigned agrees to furnish Simms Oil Company with satisfactory abstracts and other evidence of title at any time on demand and in event of failure to so furnish such evidence of title, or in case of any adverse claim of title to furnish to Simms Oil Company upon demand a suitable and satisfactory bond executed by a surety company authorized to do business in Texas, indemnifying Simms Oil Company against such claim or claims and that Simms Oil Company may retain the purchase price
61 of the oil without interest until furnished such bond or until the dispute as to ownership is settled satisfactorily to said company.

Fifth: This agreement and division order shall become valid and binding on each and every owner above named as soon as signed by him or her, regardless of whether or not any of the other above named owners have so signed.

Effective with runs beginning seven o'clock A. M. Date of first runs.

Witnesses:

(There must be two witnesses to each signature.)

FAITH OIL CORPORATION,

By ---

President.

Attest:

Secretary.

Metes and Bounds Description of O. F. Wencker 14.15 Acre Farm

Situated in the County of Gregg, State of Texas, described as follows, to-wit:

"Detailed description omitted because immaterial", as per stipulation of counsel copied at page one hereof.

* * * * * * *

62 *Plaintiff's Exhibit 6-b*

(Being the same in words and figures as Plaintiff's Exhibit 6-a shown above.)

Plaintiff's Exhibit 6-c

Simms Oil Company

Division Order

JUNE 27TH, 1932.

To SIMMS OIL COMPANY:

The undersigned certify and guarantee that they are the legal owners of wells numbered 1 and up on the Faith Oil Corp.—J. C. Barrett Farm, more particularly described as South 140 acres out of the B. W. Witcher Survey, in Gregg County, State of Texas, including the royalty interest, and until further written notice you are authorized for your own account to receive oil therefrom into your possession or the possession of any person or corporation designated by you, giving credit as directed below:

Credit to—	Division of interest	P. O. address
Faith Oil Corporation	20/32 W. I.	Wichita Falls, Texas.
Mamie S. Hammonds and Fred P. Branson (One-half each)	8/32 W. I.	623 E. 18th St. Okla. City, Ok. Skirvin Hotel, Okla. City, Ok.

Until they receive the sum of $395,000.00, out of the J. C. Barrett and other leases.

63 Simms Oil Company is hereby authorized until further notice to receive oil from said wells for purchase from the said parties severally in the proportions named. subject to the following conditions:

First: That oil run in pursuance of this division order shall become the property of Simms Oil Company as soon as the same is received into the custody of it or its designated agent.

Second: The oil received in pursuance of this division order shall be paid for to the party or parties entitled thereto according to the division of interests shown above, at such price as Simms Oil Company is currently willing to pay for oil received from the above-described lease on the day of receipt thereof. Notices of your current price basis and any changes therein are to be addressed to the undersigned at the respective post office addresses shown above. Payments to be made monthly by checks mailed to said party or parties at their respective addressed above set out.

Third: Oil shall be steamed when necessary to render it merchantable. A deduction of two percent (2%) from the oil received shall be made to cover evaporation, shrinkage, waste, or other loss. The oil must be free from sand, dirt, water, emulsion, or other sedi-

ment, and if found not to be such by the tests then in use by Simms Oil Company, may be rejected or at the option of Simms Oil Company may be accepted and when accepted Simms Oil Company shall be permitted to deduct the full percentage of sand, dirt, water, emulsion, and/or other sediment found to be contained in the oil. Corrections will be made for temperature, deducting or allowing on a basis of one percent (1%) for each 25 degrees Fahrenheit variation above or below 60 degrees Fahrenheit.

Fourth: The undersigned agrees to furnish Simms Oil Com-
64 pany with satisfactory abstracts and other evidence of title at any time on demand and in event of failure to so furnish such evidence of title, or in case of any adverse claim of title, to furnish to Simms Oil Company upon demand a suitable and satisfactory bond executed by a surety company authorized to do business in Texas, indemnifying Simms Oil Company against such claim or claims", and that Simms Oil Company may retain the purchase price of the oil without interest until furnished such bond or until the dispute as to ownership is settled satisfactorily to said company.

Fifth: This agreement and division order shall become valid and binding on each and every owner above named as soon as signed by him or her, regardless of whether or not any of the other above named owners have so signed.

Effective with runs beginning seven o'clock A. M. date of First Runs.

(There must be two witnesses to each signature.)

[SEAL] FAITH OIL CORPORATION, INC.
W. J. GREEN, *President.*
MAMIE S. HAMMONDS.
O. O. HAMMONDS.
FRED P. BRANSON.

Attest:

MRS. L. W. BREWSTER, *Secy.*
D. D. FORD.
DR. N. DEA GRIFFITH.
DR. L. RIPPETS.
D. D. FORD.

The WITNESS. These division orders, as shown in Plaintiff's Exhibits 6 a, b, c, are the customary orders used in the oil business.

65 We have connections with several pipe line companies down there, and those connections have changed from time to time; there were some changes made in the pipe lines running this oil, but the form of the division orders were always the same, and the division of the oil was always the same.

I, together with the same associates that were interested in the Branson and Hammonds property, had a property which was acquired from E. H. Brawley in the same territory. This instrument which you hand me is the oil and gas lease acquired from Mr. Brawley, for which we paid $22,500.00 cash bonus.

Mr. WEEKS. We offer it in evidence.

Mr. BACKSTROM. We object to this. There is no allegation in the petition relative to this transaction. It seems to me that it is not proper as evidence in this proceeding at all. It does not support any allegation of the petition.

The COURT. It was stated by Mr. Weeks in his opening statement, the Brawley transaction.

Mr. WEEKS. He may be correct about that. There is a few hundred dollars that came from the Brawley lease. I would like leave to cover that, is the same sort of transactions as the ones we have dealt with in our petition. This nine thousand and some odd thousand dollar income from these various properties, I think six or seven hundred dollars came from the Brawley properties.

The WITNESS. The Brawley property only has one well.

66 Mr. POTTER. We have no objection to the amendment, but we think it ought to be included.

The COURT. All right.

Mr. WEEKS. May I proceed on that theory, and sometime during the day the allegations will be made and filed,

Mr. POTTER. That is all right.

(Said instrument marked "Plaintiff's Exhibit 7" and reading as follows:)

Plaintiff's Exhibit 7

Oil & Gas Lease

Dated October 21, 1931

Filed November 2, 1931

Recorded Vol. 14, pg. 397

Upshur Co. O & G Rec.

E. H. Brawley to W. J. Green.

Agreement made and entered into the 21st day of October

67 1931, by and between E. H. Brawley and wife, Cora Brawley, of Longview, Gregg County, Texas, hereinafter called lessor (whether one or more), and W. J. Green, hereinafter called lessee:

Witnesseth: That the said lessor for and in consideration of Ten dollars, cash in hand paid, the receipt of which is hereby acknowledged, and of the covenants and agreements hereinafter contained on the part of lessee to be paid, kept and performed, have granted, demised, leased and let and by these presents do grant, lease and let unto the said lessee for the sole and only purpose of mining and operating for oil and gas and of laying pipe lines and of building tanks, power stations and structures thereon to produce, save and take care of said products, all those certain tracts of land situated in the County of Upshur, State of Texas, and containing 450 acres more or less, described as follows, to-wit:

"Detailed description omitted because immaterial", as per stipulation of counsel copied at page one hereof.

* * * * * * *

It is understood and agreed that as a part of the consideration for the execution of this lease, lessee is to pay to lessors an oil payment of forty-five thousand dollars ($45,000.00) said oil payment to be paid out of one-fourth of seven-eighths working interest.

E. H. BRAWLEY.

It is agreed that this lease shall remain in force for a term of ten years from date, and as long thereafter as oil, gas or either of them, is produced from said land by the lessee.

68 In consideration of the premises the said lessee covenants and agrees:

1st. To deliver to the credit of the lessor, free of cost, in the pipe line to which lessee may connect his wells, the equal one-eighth part of all oil produced and saved from the leased premises.

2nd. To pay to lessor, as royalty for gas from each well where gas only is found, while the same is being sold or used off of the premises, one-eighth of the market price at the wells of the amount so sold or used, the lessor to have gas free of charge from any well on the leased premises for all stoves and inside lights in the principal dwelling house on said land by making lessor's own connections with the well at lessor's own risk and expense.

3rd. To pay to lessor as royalty for gas produced from any oil well and used by lessee for the manufacture of gasoline, one-eighth of the market value of such gas. If such gas is sold by lessee, then lessee agrees to pay lessor, as royalty one-eighth of the market price at the wells of the amount sold.

If no well be commenced on said land on or before the 21st day of October, 1932, this lease shall terminate as to both parties, unless the lessee on or before that date shall pay or tender to the lessor or to the lessor's credit in the First National Bank at Longview, Texas, or its successors, which shall continue as the depository regardless of changes in the ownership of said land, the sum of four hundred fifty & No/100 dollars, which shall operate as a rental and cover the privilege of deferring the commencement of a well for twelve months from said date. In like manner and upon like payments or tenders the commencement of a well may be further deferred for like periods of the same number of months successively.

69 And it is understood and agreed that the consideration first recited herein, the down payment covers not only the privilege granted to the date when said rental is payable as aforesaid, but also the lessee's option of extending that period as aforesaid and any and all other rights conferred.

Should the first well drilled on the above described land be a dry hole, then, and in that event, if a second well is not commenced on said land within twelve months from the expiration of the last rental period which rental has been paid, this lease shall terminate

as to both parties, unless the lessee on or before the expiration of said twelve months shall resume the payment of rentals in the same amount and in the same manner as hereinbefore provided. And it is agreed that upon the resumption of the payment of rentals, as above provided, that the last preceding paragraph hereof, governing the payment of rentals and the effect thereof, shall continue in force just as though there had been no interruption in the rental payments.

If at the expiration of ten years from the date of this lease, oil or gas is not being produced on the leased premises, but lessee is then engaged in drilling for oil or gas, then this lease shall continue in force so long as drilling operations are being continuously prosecuted on the leased premises; and drilling operations shall be considered to be continuously prosecuted if not more than sixty (60) days shall elapse between the completion or abandonment of one well and the beginning of operations for the drilling of a subsequent well. If oil or gas shall be discovered and produced in paying quantities from any such well or wells drilled or being drilled at or after the lapse of ten years, this lease shall continue in force so long as oil or gas shall be produced from the leased premises.

It is specially agreed that in the event that oil or gas is
70 produced from said premises and said production shall for any reason cease or terminate, lessee shall have the right at any time within ninety (90) days from the cessation of such production to resume drilling operations in the effort to make said leased premises again product oil or gas, in which event this lease shall remain in force so long as such operations are continuously prosecuted, as defined in the preceding paragraph, and if they result in production of oil or gas, so long thereafter as oil or gas is produced in paying quantities from the premises.

If said lessor owns a less interest in the above described land than the entire and undivided fee simple estate therein, then the royalties and rentals herein provided for shall be paid the said lessor only in proposition which lessor's interest bears to the whole and undivided fee.

Lessee shall have the right to use, free of cost, gas, oil and water produced on said land for all operations thereon except from water wells of lessor. When requested by lessor, lessee shall bury its pipe line below plow depth. No well shall be drilled nearer than 200 feet to the house or born now on said premises without the written consent of the lessor; lessee shall pay for damages caused by all operations to growing crops on said land. Lessee shall have the right at any time to remove all machinery and fixtures placed on said premises, including the right to draw and remove casing.

If the estate of either party hereto is assigned and the privilege of assigning in whole or in part is expressly allowed, the covenants hereof shall extend to their heirs, executors, administrators, successors or assigns, but no change in the ownership of the land or

assignment of rentals or royalties shall be binding on the lessee until after the lessee has been furnished with a written transfer or assignment or a true copy thereof; and it is hereby agreed in the event this lease shall be assigned as to a part or parts of the above described lands and the assignee or assignees of such part or parts shall fail or make default in the payment of the proportionate part of the rents due from him or them, such default shall not operate to defeat or affect this lease in so far as it covers a part or parts of said lands upon which the said lessee or any assignee thereof shall make due payment of said rental.

71

Lessee shall have the exclusive right to build, operate, and maintain pits, reservoirs, pickup stations and plants for the purpose of picking up and conserving the waste oil that follows down the creeks, ravines, and across the land embraced in this lease, whether said oil is produced from lands covered by this lease or other lands and lessor shall be entitled to receive the royalty hereinbefore reserved on all such oil so saved.

In case of cancellation or termination of this lease for any cause, lessee shall have the right to retain under the terms hereof twenty (20) acres of land around each oil or gas well producing, being worked on, or drilling hereunder (as long as such operations are continued in good faith) such tract to be designated by lessee in as near a square form as practicable.

In the event lessor considers that lessee has not complied with all its obligations hereunder, both expressed and implied, before production has been secured or after production has been secured, lessor shall notify lessee, in writing, setting out specifically in what respects lessee has breached this contract. Lessee shall then have sixty (60) days after receipt of said notice within which to meet or commence to meet all or any part of the breaches alleged by lessor. The service of said notice shall be precedent to the bringing of any action by lessor on said lease for any cause, and no such action shall be brought until the lapse of sixty (60) days after service of such notice on lessee. Neither the service of said notice nor the doing of any acts by lessee aimed to meet all or any of the alleged breaches shall be deemed an admission or presumption that lessee has failed to perform all of its obligations hereunder.

72

Title to the minerals vested in grantee under this grant shall not end or revert to grantor until there is a complete, absolute and intentional abandonment by grantee of each and all of the purposes, expressed or implied, of this grant and every part and parcel of the premises described in this grant.

Lessor hereby warrants and agrees to defend the title to the lands herein described and agrees that the lessee shall have the right at any time to redeem for lessor, by payment, any mortgage, taxes, or other liens on the above described lands, in the event of default of payment by lessor, and be subrogated to the rights of the holder

thereof, and lessor hereby agrees that any such payment made by the lessee for the lessor shall be deducted from any amounts of money which may become due the lessor under the terms of this lease.

The $45,000.00 oil payment above referred to is not a personal obligation, but only to be paid out of one-fourth of seventh-eighths of the oil, gas, if and when produced.

E. H. BRAWLEY.

In testimony whereof, we sign this the 21st day of Oct. 1931.

E. H. BRAWLEY.
CORA BRAWLEY.

THE STATE OF TEXAS,
County of Upshur.

Before Me, the undersigned, a Notary Public in and for said
73 County and State on this day personally appeared E. H. Brawley and Cora Brawley, his wife, both known to me to be the persons whose names are subscribed to the foregoing instrument and acknowledged to me that they each executed the same for the purposes and consideration therein expressed, and the said Cora Brawley, wife of the said E. H. Brawley, having been examined by me privily and apart from her husband and having the same fully explained to her, she, the said Cora Brawley acknowledged such instrument to be her act and deed, and she declared that she had willingly signed the same for the purposes and consideration therein expressed, and that she did not wish to retract it.

Given Under My Hand And Seal Of Office this the 21st day of October, A. D. 1931.

[SEAL] ERNESTINE BOBO,
Notary Public in and for Upshur Co., Texas.

The WITNESS. The Faith Oil Company and myself were interested with Mr. Green in this lease in the same proportion as in the other lease. There was no production on that property when the lease was made. There was one well drilled on that in the extreme southeast corner, the lease being on the west side of the East Texas field, and it is producing oil. There have been two other wells drilled and both of them were dry. I have continued to own my interest through 1933 in that property, there has been no change. The production from that property was handled, with reference to its disposition and sale, in the same way as that from the Branson and Hammonds property, one-fourth of seven-eighths going to Mr. Brawley, in addition to his one eighth, and the usual form of division order. This instrument which you hand me is one of the divison orders that was used on the Brawley property.

Mr. WEEKS. We offer the instrument in evidence.

74 (Said instrument marked "Plaintiff's Exhibit No. 8" and reading as follows:)

Plaintiff's Exhibit 8

Humble Oil & Refining Company

Division Order No. 5074

Effective y a. m., August 12, 1932

To HUMBLE OIL & REFINING CO.,
Houston, Texas:

The undersigned certify and guarantee that they are the owners of the oil, including royalty interest, produced from wells, No. 1 and up, on the E. H. Brawley Farm or lease, in _____ Oil Field in Upshur County, Texas, which farm or lease is described as follows:

All that certain tract or parcel of land situated in Upshur County, Texas, being 180 acres of land on the H. R. Survey of Jackson Crouch described as follows, to-wit:

Beginning at the SE. corner of a 320-acre survey made for W. O. Barker as a pre-emption; thence south 428 vrs.; thence W. 21 vrs. corner; thence S. 428 vrs. to a stake pine brs. N. 50 1/2 E. 5 8/10 vrs. a pine brs. S. 38 W. 8 9/10; thence west 1323 vrs. a stake a pine brs. S. 70 W. 4 3/10 vrs. a pine brs. S. 25 E. 3 vrs.; thence north 874 vrs. a corner; thence east 14 vrs. corner at 1523 vrs. to beginning, containing 180 acres of land, more or less.

Until further written notice, you are authorized, for your own account, to receive such oil into your own possession or the possession of any person or corporation designated by you, same to be run and measured in accordance with the customary pipe line rules and regulations, including adjustments and deductions pro-
75 vided for by the rules of the Texas Railroad Commission, such oil to be credited as follows:

Credit to—	Division of interest	Post office address
Farmers & Merchants National Bank of Gilmer	⅞	Gilmer, Texas.
(The above interest subject to the payment to E. H. Brawley and wife of $45,000.00 out of a ¼ of ⅞ part of production.)		
E. H. Brawley & Wife, Cora Brawley	⅛	

For all oil run and purchased under this division order subsequent to 7 A. M. August 17, 1931, until further notice, or until a field price is posted as hereinafter provided, Humble Oil & Refining Company will pay what it interprets to be the going price for East Texas crude oil sold from this field during the regular settlement period during which the oil is run, exclusive of oil sold under contracts made prior to 7 A. M. June 3, 1931.

Humble Oil & Refining Company does not have a posted price for oil from this field at this time, but if and when Humble Oil & Refining Company does post a regular price for oil in this field, from

such time and thereafter, until further notice, such regular posted field price shall control and shall govern purchases thereafter made under this division order.

The oil run hereunder shall on the terms herein contained become the property of Humble Oil & Refining Company immediately upon being received into the possession of said Company or its designated agent, and said Company agrees to receive and pay for such oil to the respective owners according to the division of interest hereinabove indicated at its posted per-barrel (42 gallons) field price for similar crude in the field where received prevailing on the date of each respective run, settlements, and payments to be made
76 monthly by check of Humble Oil & Refining Company mailed to the respective parties at the addresses above given.

Each undersigned hereby warrants and guarantees the title to the oil credited to such undersigned owner according to the division of interest hereinabove indicated, as well as all interest hereafter acquired, and agrees to furnish abstract of title, and in case of any adverse claim of title to such oil or any part thereof, or to the land from which such oil is produced, to furnish Humble Oil & Refining Company satisfactory indemnity bond against such adverse claim or claims and to authorize Humble Oil & Refining Company to retain the purchase price without any obligation to pay interest on the amount so withheld until such bond shall be furnished or until dispute as to the ownership is settled.

FARMERS & MERCHANTS
NATIONAL BANK OF GILMER,
By H. J. CHILDRESS, *President.*

Attest:

C. T. CROSBY, *Cashier.*
FAITH OIL CORPORATION.
By W. J. GREEN, *President.*
C. T. CROSBY,
E. H. BRAWLEY,
CORA BRAWLEY.

Witnesses.:
Attest:

----------,
Secretary.
J. P. RAY,
J. M. LOCKHART,
L. S. BRAWLEY.

Accepted and agreed to:

HUMBLE OIL & REFINING CO.,
By ----------

77 The WITNESS. That division order provides for our portion of the oil to go to the Farmers and Merchants National Bank, it went to them as a pledge for an indebtedness, but the proceeds were for our account.

My experience has been, in respect to transactions of this character, that we could not have collected for any portion of the oil applicable to the oil payment under any consideration, except by the written consent of the holders of the oil payment given to the pipe line companies running the oil.

I am quite sure that the Branson and Hammonds Oil payment will be paid out within two and a half years, from this time; that statement is based upon the geology and experience we have had over in the East Texas field. Approximately one-half of that $395,000.00 has been paid at this time. In respect to the Brawley payment, there is no chance for that to pay out. We only have one well, and I don't think we will ever drill any more, because this well is making a large amount of water. It will probably produce, from the best information available, two or three years more—so that the Brawley payment is the same as a perpetual royalty.

In making my tax returns for the year 1933, this fraction of the oil and its proceeds which went to Branson and Hammonds in the one instance and Brawley in the other, was not included by me as part of my income. It was not included in our original tax returns, but was set up by the revenue agent when he audited our returns at a later date.

I owned an interest in some property in Moore County, West Texas, known as the Ozier Ranch. I bought one-third interest in the west half of the Ozier Ranch, consisting of about fifty-three hundred acres, from Will O'Brian. I agreed to pay him ten thousand dollars for that third interest and take it subject to some sixty thousand dollars original first lien vendor lien notes against the en-
78 tire Ozier Ranch, consisting of a little over ten thousand acres. This instrument which you hand me is a copy of the deed by which I acquired that one-third interest.

Mr. WEEKS. We offer the deed in evidence.

(Said instrument marked "Plaintiff's Exhibit No. 9" and reading as follows:)

Plaintiff's Exhibit No. 9

THE STATE OF TEXAS,
County of Potter.

Know All Men By These Presents: That I, W. O'Brien and wife, Exie E. O'Brien, of the County of Potter, State of Texas, for and in consideration of the sum of Ten Thousand ($10,000.00) cash paid to us in hand paid by J. J. Perkins, the receipt whereof is hereby acknowledged, have granted, sold, remised, released and forever quit claimed and by these presents do grant, sell, remise, release and forever quit claim unto the said J. J. Perkins, his heirs and assigns all our right, title and interest in and to that certain lot, tract or parcel of land described as follows:

A one-third undivided interest in all of Section 53, 54 and 55, in Block 47, H. & T. C. Ry. Co., each containing 640 acres of land; all

of Sections 50, 51, 76 and 79 in Block G. & M. 3, Sections 50, 51 and 76 and 79 in Blocks G. & M. 3, Sections 50, 51, and 76, containing 640 acres of land, and Section 79 containing 282.2 acres of land, all of Section 77 in Block G. & M. 3, containing 426.2 acres of land, same being all of said Sections deeded to W. R. Ozier by R. B. Masterson.

79 Section Number (10) in Block B 12, D. & R. P. Ry. Co., containing 640 acres of land, Section number 48, in Block G. & M. 3, containing 192 acres, and being all of said section deeded to W. R. Ozier by R. B. Masterson.

This deed is intended to convey and does convey a one-third interest in all of the lands purchased by W. O'Brien when sold by the Sheriff of Moore County, Texas, on the 7th day of August 1923, and for further descriptions of said above described land, reference is made to said sale.

To Have And To Hold the above described premises together with all and singular the rights and appurtenances thereto in anywise belonging unto the said J. J. Perkins, his heirs and assigns forever, so that neither the vendor herein nor their heirs, nor any other person or persons for themselves or in their name or behalf, shall or will hereafter claim or demand any right or title to the aforesaid premises or any part thereof, but they and every one of them by these presents shall be excluded and forever barred.

Witness our hand this 8th day of November, A. D. 1925.

W. O'Brien.
Exie E. O'Brien.

The State of Texas,
County of Potter.

Before Me a Notary Public in and for County of Potter of the County in the State of Texas on this day personally appeared W. O'Brien and Exie E. O'Brien, his wife, both known to me (or proved to me on the oath of ____) to be the persons whose names are subscribed to the foregoing instrument and acknowledged to me that they each executed the same for the purposes and consideration therein expressed. And the said Exie E. O'Brien, wife of the said W.

80 O'Brien, having been examined by me privily and apart from her husband and having the same fully explained to her, she, the said Exie E. O'Brien, acknowledged such instrument to be her act and deed and declared that she had willing signed the same for the purposes and consideration therein expressed, and that she did not wish to retract it.

Given Under My Hand And Seal Of Office this 8th day of November, A. D. 1925.

[seal] H. V. Knupp.

Filed December 15, 1925, at 9 o'clock A. M.

Recorded January 2, 1926—Volume 27, page 458.

The Witness. I will outline briefly the circumstances under which I acquired that property; Mr. O'Brien, of Amarillo, who is a very close personal friend of mine, came down to Wichita Falls and told

me that he had acquired, through a foreclosure of a deed of trust, that was given to his bank, the National Bank of Commerce of Amarillo, what he termed the west half of the Ozier Ranch, and that it was subject to the original purchase money notes given for the purchase of the entire ranch, by Mr. Ozier. The notes at that time being held by Mr. Masterson, and being past due, he said that he felt that an effort was being made for those notes to be foreclosed on in such way as to wipe out his interests. He asked me if I would not advance the money to take up the original purchase money notes, and file suit for a foreclosure of that lien, marshaling the assets by selling the East half of the ranch, and if that sold for enough to pay, it would have the effect of wiping out the lien on the entire ranch, if it did not sell for enough, then they would sell the west half. I told him I would, and I gave him a check at that time for the $59,000.00, and he took it back to Amarillo and took up the notes from Mr.
81 Masterson and immediately turned them over to Judge Reeder to file suit to foreclose the lien.

This deed from Mr. O'Brien to me is dated November 8, 1925. This other transaction in respect to these notes held by Masterson was the—the last of January, 1924 is when I made the trade and entered into a contract with Mr. O'Brien, but I did not take title; that is also when I paid off the notes, in January, 1924, but I did not take title until after the entire matter was cleaned up through the Courts. This suit that was instituted by me on the Masterson note, was prosecuted to a conclusion, and the Court ordered that the east half of the Ozier Ranch be sold to satisfy a judgment, which was with interest and attorney's fees, nearly seventy thousand dollars, and the land was sold under execution in September, 1924. However, the judgment was appealed from and went on finally to the Supreme Court of Texas, but the land was sold under the execution issued from that judgment, September, 1924. I think the land brought ten dollars more than the entire amount of the judgment. Jim Shelton, Mr. Ozier's son-in-law, bought it.

The agreement I made with Mr. O'Brien, in January, 1924, was that I was to take a one-third interest in the west half, Mr. O'Brien retain one-third interest, and Mr. Lee Bivins one-third interest. In 1933 Mr. O'Brien and I sold our two-thirds interest in the west half of all the mineral on that ranch to the Amarillo Gas Company, the Bivins estate did not join in the sale. This instrument which you hand me is the instrument by which the minerals were conveyed. There was a small portion of the mineral outstanding in three sections when we bought the ranch, being owned by Mr. Kay and others, and they joined in the sale at the same time we sold ours.

Mr. WEEKS. We offer the instrument in evidence.

82 (Said instrument marked "Plaintiff's Exhibit No. 10" and reading as follows:)

Plaintiff's Exhibit No. 10

STATE OF TEXAS,
Counties of Moore & Potter:

Know All Men By These Presents: That, Whereas, W. O'Brien, W. L. Mathers and J. J. Perkins own an undivided 2/3rds interest in the mineral estate in and to the land hereinafter described as Tract No. 1, and an undivided 5/12ths interest in the mineral estate in and to the tract hereinafter described as Tract No. 2 and own an undivided 2/3rds interest in the surface estate in and to all of the land hereinafter described, and A. W. Kay, Finley Scruggs Jr. and C. B. Dodge own an undivided 12/40ths interest in the mineral estate in and to the lands hereinafter described as Tract No. 2.

Now, Therefore, Know All Men By These Presents: That we, W. O'Brien and W. L. Mathers, of Potter County, Texas, J. J. Perkins of Wichita County, Texas, A. W. Kay of Young County, Texas, Finley Scruggs, Jr., of Smith County, Texas, and C. B. Dodge of Saline County, Kansas, for and in consideration of the sum of $45,686.66 cash in hand paid by Amarillo Oil Company a corporation, receipt of which sum is hereby acknowledged, have granted, sold, assigned, conveyed and delivered and by these presents do grant, sell, assign, convey and deliver unto the said Amarillo Oil Company, a corporation, organized and existing under the laws of the State of Texas, an undivided 2/3rds interest in the oil, gas and other minerals in, under and that may be produced from the land hereinafter described as Tract No. 1 situated in Moore and Potter Counties, Texas, to-wit:

Tract No. 1:

All of Sections 50, 51, 76, and 79 in Block No. G & M 3,
83 said sections 50, 51, and 76 containing 640 acres each, and section 69 containing 282.3 acres of land; all of section 10, Block B-12, D. & P. Ry. Co. survey, containing 640 acres; all of section 77, Block G & M 3, containing 426.5 acres, and the east part of section 48, Block G & M 3, containing 192.2 acres. Reference is here made to the deed records of Moore County, Texas, for an exact description of that portion of Section 48 herein conveyed.

and an undivided 86/120ths interest in the oil, gas, and other minerals in, under, and that may be produced from the land hereinafter described as Tract No. 2, situated in Moore and Potter Counties, Texas, to-wit:

Tract No. 2:

All of sections 53, 54, and 55, in Block No. 47, H. & T. C. Ry. Co. Survey, each containing 640 acres;

All of said tracts containing in the aggregate of 5,381 acres, more or less.

together with the full right of ingress and egress at all times for the purpose of mining and operating for oil or gas and other minerals,

and of laying pipe lines and the erecting of telegraph and telephone lines, and of building tanks, power stations, and structures, and notwithstanding the above enumeration, the full right to go upon said lands and use the same for any purpose reasonably necessary or incident to the operations upon said lands for the purpose of mining, drilling, and exploring the same for oil, gas, and other minerals, and removing the same therefrom. The grantee herein, its successors and assigns, shall have the right to use, free of cost, water produced on said lands for its operations thereon, except water from wells or tanks of the grantors herein.

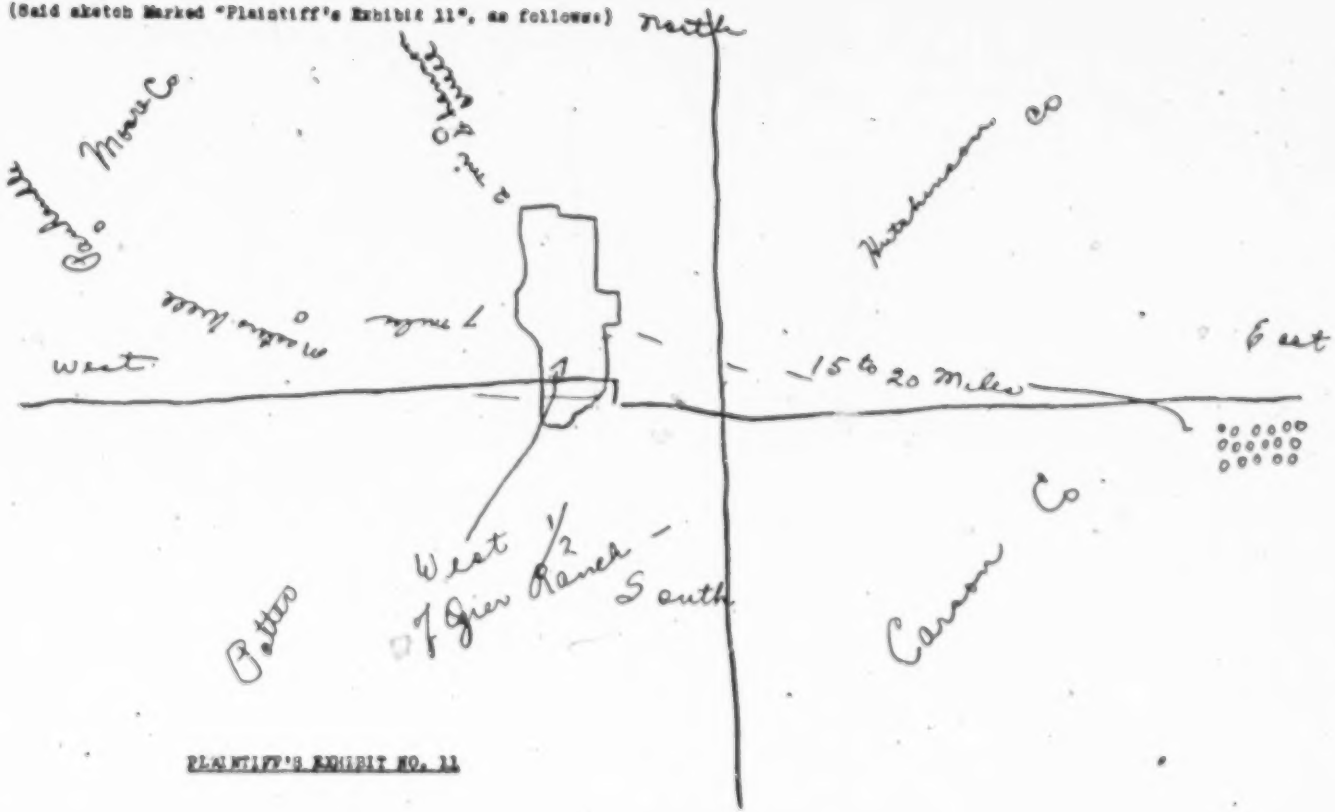
This mineral conveyance shall cover and include all lands
84 owned by the grantors herein as excess acreage in or contiguous to the surveys or descriptions as above set forth, and shall cover and include all of the mineral interest and estate that the grantors herein have in and to the surveys hereinabove described, whether the description hereinabove contained is absolutely accurate or not.

Said land is now under an oil and gas lease executed in favor of Amarillo Oil Company dated May 23, 1928, and recorded in Volume 37, page 368, of the Deed Records of Moore County, Texas, reference to which is here made, and it is agreed and understood that this sale is made subject to the terms of such lease, but covers and includes 2/3rds as to Tract No. 1 and 86/120ths as to Tract No. 2 of the oil royalty and gas rental and royalty due and to be paid under the terms of said lease.

It is understood and agreed that 2/3rds as to Tract No. 1 and 86/120ths as to Tract No. 2 of the money rentals which may be paid to extend the terms within which a well may be begun under the terms of such lease is to be paid to the grantee herein, its successors and assigns, and in the event that the above described lease becomes canceled or forfeited or terminates for any cause whatsoever, that then, and in that event, 2/3rds as to Tract No. 1 and 86/120ths as to Tract No. 2 of the mineral estate and future rentals, whether delay rentals or otherwise, and bonuses on said land for oil, gas, or other mineral privileges shall be owned by the grantee herein, its successors and assigns.

To Have And To Hold the above described property, together with all and singular the rights and appurtenances thereto in any wise belonging unto the said Amarillo Oil Company, its successors and assigns, forever, and the grantors herein do hereby bind themselves, their heirs, executors, and administrators, to warrant and for-
85 ever defend all and singular the property herein conveyed unto the said grantee herein, its successors and assigns, against every person whomsoever claiming or to claim the same, or any part thereof. It is understood, however, that this warranty as to A. W. Kay, Finley Scruggs, Jr., and C. B. Dodge shall be and is limited to the interest herein conveyed by them, as hereinabove set out, and the warranty of the other grantors herein shall extend to the remainder of the property herein conveyed, as hereinabove set out.

(Said sketch Marked "Plaintiff's Exhibit 11", as follows)



PLAINTIFF'S EXHIBIT NO. 11

"Acknowledgments and recording data omitted because immaterial", as per stipulation of counsel copied at page one hereof.

* * * * * * *

The WITNESS. Prior to that time I had been operating in the oil business in the Panhandle in the neighborhood of this Moore County property. I owned a fourth interest in the Dial Ranch in Hutchinson County, about fifteen miles East of the Ozier Ranch. I think that is all the properties I had at that time up there. The Dial Ranch only had one little well on it, however, we bought the Dial ranch as an oil possibility when we bought it. I was familiar with the course of oil and gas development in the Panhandle area at the time of this transaction with Mr. O'Brien. As to the prospects on this Ozier Ranch, the part of it which I acquired an interest in, as to producing gas and oil on the date of the deed from Mr. O'Brien to me in 1925, I will state there had been drilled three gas wells to the west and northwest of the Ozier Ranch from two to five miles; and there had been some production found on the north line of the Burnett Ranch on the north line of Carson County, some fifteen or eighteen miles east and a little south of the Ozier Ranch. So that the Ozier Ranch was in between the two gas wells and the oil as
86 it had been found. And the oil and gas possibilities is the only reason that I would have considered buying the Ozier Ranch at all. I had no interest in it other than from an oil-and-gas standpoint. At the time I bought this property from Mr. O'Brien I felt quite certain that it would produce gas, and we were hoping it would produce oil, and from that standpoint I felt that it would be a good investment to buy it, so I bought it.

I have a map of that territory out there, which covers several counties in the Panhandle.

I would like to correct one statement before going into that; you asked me if I had any other oil interest in the Panhandle; I had a small interest in the Shamrock well, being one of the wells drilled on the west or northwest of the Ozier Ranch, three or four years prior to the time I made this trade, and I still owned that interest at the time I bought the Ozier Ranch propery.

This map here correctly reflects the location of this land with respect to the various counties and their boundaries up there.

I have prepared a sketch which correctly shows, with substantial correctness, the location of this Ozier Ranch, the part of it in which I was interested, and the county lines up there. This instrument which you now hand me is the one I prepared.

Mr. WEEKS. We offer it in evidence.

88 The WITNESS. This irregular shaped piece of land here is the Ozier Ranch, that is the west half of it; that lies principally in the south east corner of Moore County, and extends into the north east corner of Potter County.

In 1925, when I bought this interest in the Ozier Ranch, there was some develop on the east.

Mr. BACKSTROM. He acquired the ranch in 1924, I think it is immaterial as to what was there in 1925.

The COURT. That is the way I view it.

Mr. WEEKS. The deed is dated in 1925.

The COURT. He has said that it was 1924, you had to refresh his memory.

Mr. WEEKS. Well, on the west half was 1924, his deed from Mr. O'Brien was dated November 8, 1925.

Mr. BACKSTROM. He alleged in his petition in 1924, and we admitted that.

Mr. WEEKS. Well, then, I will confine our testimony to that time.

The WITNESS. As to the condition existing in 1924, at the time Mr. O'Brien first came to me about the matter, I will state; at the time I made this contract with Mr. O'Brien in January 1924, there
89 was one small well on the Dial Ranch, it is north of the Canadian River in Hutchinson County, about twenty miles east and a little north of the Ozier Ranch property. There were a substantial number of wells on the north line of the Burnett Ranch, along the north line of Carson County, about twenty miles east and a little south of the Ozier Ranch. Some of those wells were oil wells and some of them gas wells. At the time I bought the Ozier Ranch, there had been a well drilled by the Shamrock Oil and Gas Company in which I had an interest, completed in May 1922, and made forty million feet of gas. That was on the Sneed Ranch on Section 42, T. & N. O. R. R. Company survey, Block 6, T. That was about two or two and a half miles northwest of the north line of the Ozier Ranch. Then some seven miles due west of the Ozier Ranch was the Masterson Oil and Gas Well, which was completed September 30, 1920. I, likewise, had an interest in that well. Then there was completed in November 1921, about twelve miles west of the Ozier Ranch, a well by the Panhandle Refining Company on the Thompson Ranch. This well was on Section 24, E. L. & R. R. Co. Survey, Block 26. I have marked those wells upon the sketch, Plaintiff's Exhibit No. 11, which has been offered in evidence.

I have had rather extensive experience in trading in land in this particular west Texas territory, I have had rather extensive dealings in land all over the entire Panhandle territory, for a period of perhaps twenty-five years. When I say extensive, I mean, I have bought and sold seventy-five to one hundred thousand acres of land, in perhaps fifty or one hundred different tracts over the panhandle. Previous to this time, I had acquired an interest in the Dial Ranch in 1922, which was eleven thousand acres, with a consideration of about $100,000.00. The other transactions I have spoken of, were in substantial amounts, I would imagine the entire consideration would be in excess of half a million dollars, or probably a million dollars.

90 This Ozier Ranch was rough pasture land, there was very little of the land that should have been put into cultivation. I had no interest in it, except from a mineral standpoint, when I

bought it, aside from the mineral in the land I would not have considered it, because it had no value to me from any standpoint except as to minerals. In my opinion the value of this property, that is, the cash market value at the time I made this trade with Mr. O'Brien, disregarding any mineral or oil or gas value which the property might have, I would not value it over $3.00 per acre as a maximum. I would say the value of the east and west half was approximately the same—I think that is true with reference to both the mineral and the surface value, that is, one is as valuable as the other, from a mineral standpoint, at that time.

Since I disposed of the minerals in the west half of the Ozier Ranch, I have disposed of the fee, for which I received $3.75 per acre, with $1.00 per acre in cash and the balance in one, two, and three years.

Q. What, in your opinion, is a fair apportionment between the value of the minerals in the west half of the Ozier Ranch at the date you acquired it, and the value of the surface?

Mr. BACKSTROM. We think that is objectionable. I think that is calling for a legal conclusion of the witness, to testify what the values were. What is a fair apportionment, I don't think is a proper opinion of the witness. I think that is a matter for Your Honor to determine, as a matter of law.

The COURT. I don't know about it being a matter of law, but I think it is probably for the determination of the fact finder; but the fact finder has to have some facts upon which to find. Here it is alleged mineral sale, an alleged sale of the realty outside of
91 the mineral, the fee, as it is called already in evidence, being unsatisfied with that the plaintiff offers to testify what is his opinion as to a fair apportionment.

Mr. WEEKS. It seems to me that the question is substantially the same as if we were attempting to determine how much of the total value of the piece of property is represented by the buildings and represented by the lot itself. Certainly a man would have to qualify to express an opinion; I think he should testify as to that; and just as easily and properly, it seems to me, an apportionment of the value of the fee and the surface can be made by witness knowing the property and otherwise qualified.

The COURT. You don't think the selling price is sufficient indication of apportionment?

Mr. WEEKS. Of course, the selling price of the surface in 1936 is quite remote from this acquisition, beginning in 1924 and consummated in 1925.

The COURT. In view of the objection, couldn't you figure it around and make it a little less remote?

The WITNESS. At the time I bought the land, I regarded the mineral as being worth perhaps three times as much as the surface, and I don't think there has been any change of any consequence since that time. During the time of our ownership we attempted to lease this

land for grazing purposes, but we received very little revenue from it. I was not in the ranching business, but I would say a fair grazing revenue for it would be about fifteen or twenty cents per acre.

The east and west half of this Ozier Ranch contained approx-
92 imately the same number of acres; there may have been two or three hundred more acres in one side than the other; there was supposed to be between ten and eleven thousand acres in the whole ranch, and there was five thousand three hundred and eighty-one acres in the west half.

Going back to the East Texas matters, we never received any portion of the money that was to be applied on the oil payments, and could not have received any portion of it except by the written consent of the owners of the payment—the money belonged to them; it did not belong to us.

I have my 1933 tax return available—I have both of my returns. Both of those returns report ordinary income and items of capital gain, the Ozier Ranch proposition being reported as a capital gain item; and the East Texas proposition coming within the ordinary income as I reported it.

Mr. WEEKS. There are some formal matters that we are in agreement about, and at this time we will not encumber the record with matters of that sort.

Cross-examination by Mr. POTTER:

The contract for the purchase of the land in Moore County was made in 1924; I was to receive one-third interest in five thousand three hundred and eighty-one acres, subject, of course, to the outstanding indebtedness against the entire ranch. As the matter terminated that indebtedness was wiped out by a foreclosure proceeding and a sale of half the ranch—that is, the east half. At the time I made the contract there was an indebtedness on it, but it was wiped out through the Court proceeding. The execution of the deed was only a formality carrying out the contract made in January 1924. I paid $10,000.00 for the one-third undivided interest in the west
93 half. I sold the surface rights in the land for $3.75, amounting to about $6,500.00. As to the value of that character of land, just as a surface proposition, I would say there has been little change in the value since the time I bought it, because it could not be used for anything except grazing purposes. I would assume the value in 1924 is about the same as it was in 1936.

I paid approximately $5.50 for this land in 1924, and sold it for $3.75 on terms. I do not think the value of the mineral rights was the difference between what I paid for it and what I sold the surface rights for, because I took the hazard of having to pay more than as much more than that for the land, that is, than I actually paid, however, it worked out that I didn't have to pay it, through this litigation. The east half actually brought $10.00 more than the amount of encumbrance against it, but I forced that issue by bidding on it myself. I bought the surface and the mineral rights

both for $5.50, and sold the surface rights for $3.75. There has been no material change in the surface value of that land between 1924 and 1936.

There was a substantial increase in the value of the mineral rights after my purchase in 1924, and before I sold the mineral rights in 1933, because in 1933 I sold it for $20.00 per acre for the minerals. I did not buy the minerals for $1.70 in 1924, we bought the land and minerals both for the $10,000.00, and perhaps $10,000.00 more contingent upon other matters, but which we did not have to pay, all we actually paid was $10,000.00, after about three years' litigation.

There was a material increase in the value of the mineral rights in this land between 1924 and 1933, but I could not tell you what the increase amounted to on a proportional basis, or on a percentage basis. I sold in 1933 for $20.00 per acre, but the value in 1924 was a speculative value, however, that value was sufficiently definite that I was willing to put my money into it, just as I bought many oil and gas leases on other lands. As to the values of min-
94 erals in the land in 1924, I would think three-fourths of the value of our purchase price was represented by mineral and one-fourth by surface values. If this land was worth $20.00 per acre in 1933 when we sold it, my testimony is not that in 1924 it was worth $15.00 per acre, because we were not paying what we thought we might be able to get out of it, we thought we would make a profit. I could not tell you what was the reasonable market value of the mineral rights in this land in 1924. I think at that time it was proven beyond any question that it would produce gas, and we were hoping it would produce oil and we were buying it just as cheap as we could buy it. I think in 1924 the values of the mineral rights were considerable in excess of what we paid but I couldn't tell you what that value was. I had interests in other land around in that territory, I had a one-fourth interest in fee ownership of the Dial Ranch, twenty miles away, and I had a small interest in two of the gas wells that had been drilled west of the Ozier Ranch. The value of these mineral rights on this particular land would be wholly conjecture. It was a speculative value, the oil business is a speculative proposition. The speculative value was whatever you could get for it.

It is a fact that we paid $5.50 per acre for this land in 1924, and sold the surface rights in 1936 for $3.75. I thought I was buying it for very much less than its value when I bought it, by reason of the peculiar conditions.

I was sufficiently familiar with the fair market value of mineral rights in property located as this property was in the south east section or portion of Moore County, Texas, in 1924, that I was willing to invest my money in and buy it as a speculative proposition. I do not recall any sales of this character of land at that time in Moore County, I lived in Wichita Falls, and I would only be up there occasionally.

95 We had very little income from this property for grazing purposes during the time we held it, during the entire time I would think we received about $1.00 or 75 cents per acre, part of the time we were not able to collect any rent. It was worth about fifteen cents per acre per year, and part of the time we were not able to collect any rents at all. For my one-third interest I received about thirty or thirty-three and a third cents per acre during the entire time I had it, perhaps not much more than enough to pay the advalorem taxes on it. We also sold one pipe line right of way for two or three hundred dollars consideration, and then we sold an oil & gas lease in the property in 1928, for which we got $25.00 per acre, that was a lease on the mineral, to the Amarillo Gas Company—that was in addition to the sale of the entire mineral rights. This was a five year lease and the least was expiring in 1933, and that was the reason we were able to sell the mineral. I did not receive quite one-third of the $25.00, some parties at Graham owned three-eighths interest in the mineral under three sections, but roughly I received one-third, Mr. O'Brien one-third, and Mr. Bivins one-third.

Redirect examination by Mr. WEEKS:

As to the sale under foreclosure that was made in 1924, the lien covered the entire ranch, fee, mineral, and oil, and the east half including the surface and the mineral was the one cut out and sold to satisfy the judgment. That price was paid in cash. The date of the deed for that sale under foreclosure was September 1924. I would say that between that date and the date I made my trade with Mr. O'Brien, which was in January 1924 there had been on change of any significance in the surface value. The trading had gotten considerably more active on minerals, and oil leases, within that time, there was a great deal of interest being manifest in the oil development in that general section during the year 1924.

96 *Stipulation as to income*

Mr. WEEKS. If Your Honor please, the parties stipulate that in their 1933 tax returns, Mr. and Mrs. Perkins reported a net ordinary income, for both of them, of $42,993.74; and an income from capital gain for both of them, of $32,084.84; a total of both ordinary income and capital gain, amounting to $75,078.58.

The east Texas proposition involved in this record came into the ordinary income item, and the Ozier ranch transaction, went into the capital gain item. This was increased by the commissioner of internal revenue upon review, because primarily of the matters here involved, and ordinary net income for both of them fixed at $51,217.01, and the capital gain income at $42,371.21, for both of them, a total of $93,588.22.

Mr. WEEKS. The answer, if Your Honor please, takes care of the allegations as to the amount of taxes paid, date of payment, and thing of that sort.

The answer also contains an allegation that in the event this oil payment item should be excluded from the income of Mr. and Mrs. Perkins, the depletion heretofore allowed them should be correspondingly reduced. The figures are given in the defendant's answers, being a reduction in the depletion allowance of $2,919.16.

The plaintiffs concede the correctness of that allegation under the circumstances which it made, and we say further that with the permission of the Court the parties can readily agree as to the facts and figures to be incorporated into the judgment that might be rendered, and if it is satisfactory with the Court, we will not encumber the record with any detailed calculations of the tax liability and the interest on it.

Whereupon both sides close.

97 *Motion of plaintiff for judgment*

Mr. WEEKS. I have a motion for a judgment for the plaintiff which I would like to file at this time.

The COURT. Is there a motion by the defendant for judgment also?

Motion of defendant for judgment

Mr. POTTER. Yes, sir; the defendant makes a motion for judgment.

III

The plaintiffs then introduced the following additional testimony, to-wit:

JUNE 11, 1936.

J. J. PERKINS, one of the plaintiff, being first duly sworn, examined in chief by Mr. Weeks, testified as follows:

I am J. J. Perkins, one of the plaintiffs in this case, who testified at the previous hearing; in connection with the Ozier Ranch proposition there was some testimony at the previous hearing to the effect that I bought from Mr. Masterson a vendor's lien note on all of the Ozier Ranch, and that at the foreclosure sale a sufficient sum was realized to pay off that note and interest; in connection with that matter I will tell you how that was handled in my tax returns for those years; I bought that note and immediately turned it over to my attorney, and he brought suit to foreclose the lien. Out of the transaction there was a profit of about $2,000.00, brought about largely by reason of the note calling for ten percent attorneys' fees, and the attorney only charged $3,000.00. There was about
98 $2,000.00 in addition to the interest charge on my investment in the note, and that was divided equally between Mr. O'Brien, Mr. Bevans, and myself. That profit was reported for taxation when I received it. It was the interest that I received, and the extra profit, my portion of $11,653.00, were both included in my tax return of that year.

In 1928 myself and associates owned the west half of the Ozier Ranch and made a sale of the oil and gas lease and received a substantial bonus which was reported as income, with a deduction of $5,000.00 as the cost of the lease in my 1928 return. And, when the auditor checked me up, he disallowed any part of the money I deducted for that, the cost of the lease, so that it was then turned in and paid as profit for the year 1928. In other words, the entire portion of this bonus which went to me was treated as taxable income by the taxing authorities, and without any allowance for returning invested capital. However, I think we took depletion on that, but I am not positive—there has been some confusion as to those things. I have some papers here that I can check that from later.

In 1933, after my associates and I had sold the minerals on the Ozier Ranch, we made an effort to dispose of the surface; in that year we made two different efforts to sell it, and offered it for $5,000.00 for my interest in the property, with instructions if they could not get the $5,000.00 that I would take $4,000.00. It was a rough piece of ranch land, and I had no use for it, and the mineral value was the moving incentive when I bought the property; since I sold it, I had no interest in the surface. But I was not able to sell it that year and was not able to sell it until 1936. I believe it is a matter of former evidence, that in my 1933 return I deducted $7,500.00 of my cost as being the cost of the mineral, and that has been disallowed and I have paid taxes on the full amount without deduction of any kind.

99 In connection with my claim for refund I received a letter from the Commissioner of Internal Revenue advising as to the reasons why my claim was rejected. This is the letter here, marked Exhibit A.

Mr. WEEKS. We offer the letter in evidence.

(Sail letter marked "Exhibit A", reading as follows:)

Exhibit A

TREASURY DEPARTMENT,
Washington, Dec. 16, 1935.

Office of Commissioner of Internal Revenue

Address Reply to Commissioner of Internal Revenue and refer to IT:AR:E–1 NF.

Mr. J. J. PERKINS,
Post Office Box 1470, Wichita Falls, Texas.

SIR: Reference is made to your claim for refund in the amount of $1,442.07 income tax and interest for the taxable year 1933.

The basis of your claim is the statement that oil reserves in respect to oil properties in East Texas, as adjusted in the report of the internal revenue agent in charge, Dallas, Texas, are excessive, and

that capital net gain reported from the sale of your interest in all the minerals underlying the Ozier Ranch in Moore County,
100 Texas, was erroneously increased by $7,500.00 in the agent's report.

A review of the case discloses that in accordance with the terms of the contract, whereby a working interest in certain East Texas oil and gas leases was acquired for cash and additional payments to be made out of a fraction of the oil produced, oil payments of $19,229.03 made during 1933 have been included in taxable income subject to percentage depletion and also in leasehold cost returnable through cost depletion. This action is in accordance with the decision of the United States Circuit Court of Appeals for the Eighth Circuit in the case of the Comar Oil Company, 64 Fed. (2d) 965, certiorari denied by the United States Supreme Court, 54 S. Ct. 69, in which it was held that where certain oil and gas leases were transferred to the petitioner by assignments in consideration for a certain amount of money to be paid partly in cash and partly out of oil and gas as produced from the leased property, the royalties paid as deferred payments in 1923 constituted taxable income to the petitioner and also represented capital transactions not deductible as expenses. The treatment of this item in the revenue agent's report is therefore approved by this office.

With reference to the other item covered by your claim, it is disclosed that in 1924 an interest in the Ozier Ranch in fee was acquired at a cost of $10,000.00. In 1933 all of the mineral rights in the property were sold to the Canadian River Gas Company, the share of you and your wife in the proceeds amounting to $31,073.33. In reporting the transaction, three-fourths of the original cost of fee, or $7,500.00, was deducted as being the cost of the minerals sold. The internal revenue agent disallowed the cost claimed in accordance with the decision of the United States Circuit Court of Appeals for the Ninth Circuit in the case of the Coalinga-Mohawk Oil Company, 64 Fed. (2d) 262, certiorari denied by the United
101 States Supreme Court, 54 S. Ct. 69. In that case it was held that where the taxpayer purchased land in 1918 solely as an oil prospect or because of its supposed oil content and in 1921 determined that the land was nonoil bearing and offered it for sale as grazing land, no sale being made until 1923, no deductible loss of a part of the original cost of the property was sustained in 1921 within the meaning of section 234 (a) (4) of the Revenue Act of 1921. Since at the time of the acquisition of the Ozier property by you no segregation of mineral and surface values was made on the basis of $10,000.00 for approximately 1,800 acres of grazing land, it appears that no more was paid for the lands than their value as grazing lands. Therefore the entire amount of $31,073.33 is considered to be taxable income.

For the foregoing reasons, your claim will be disallowed. Official notice of the disallowance of your claim will be issued by registered

mail in accordance with section 1103 (a) of the Revenue Act of 1932.

Respectfully,

CHAS. T. RUSSELL,
Deputy Commissioner.
(Signed) By H. B. ROBINSON,
Head of Division.

The WITNESS. I sold for $6,500.00 in 1936. If I may transgress just a little bit, we bought a third interest in the west half of the Ozier Ranch for $10,000.00, the entire ranch being subject to $60,000.00, vendor lien notes. At the time I made that purchase, I expected the west half to have to pay its proportionate part of these notes, which would have made the west half cost half of that lien, or $30,000.00, plus $30,000.00 we actually paid, would have been $60,000.00 that the west half would have cost us, so that my part would have cost me $20,000.00. That is what I expected to
102 have to pay for it. However, my associate, Mr. O'Brien, said that the assets could be marshaled in such a way that the east half would pay the entire notes and we would not have to pay any thing, and that was worked out through the Courts. And we did not have to pay any part of the vendor lien notes that were a lien on the entire ranch, because the east half sold for a sufficient amount to pay the entire debt, leaving our west half free of any liens.

I did not have any connection with the East half of the Ozier Ranch, except as a lien holder; and had I had to pay my proportionate part of the lien on the west half, the property would have cost me between $11.00 and $12.00 per acre, and I valued at that time, three fourths of the value as mineral and one fourth as surface. At the foreclosure sale that was made in September, after I made this trade in January, 1924, the east half sold for between $13.00 and $14.00, and the increased price over what I thought I had to pay represented the greater interest being manifested in the minerals and oil and gas possibilities in that area from the time I made the purchase until I sold it—or rather, until the east half was sold.

Q. Mr. Perkins, in connection with your work in the oil business, have you had occasion, on numerous times, to observe and ascertain the practices of the Bureau of Internal Revenue, with respect to the taxation of income from gas and oil leases and from gas and oil royalties?

Colloquy

Mr. BACKSTROM: We object to that. In the first place, I think it is immaterial to any issues involved. In the second place, if it is material, it is not the best evidence.

The COURT. I am afraid of that question, Mr. Weeks; I may not see it at all, but I think it is a good objection.

103 Mr. WEEKS. Your Honor, I think the administrative practices of the department of the government, charged with the enforcement of a law, are always material in the interpretation. Sometimes we can have official records showing what those practices are. When we have, I think they are certainly proper evidence.

The COURT. Yes; I think that is correct——

Mr. WEEKS. But I don't think we should be confined to them. In this case, we do not have the detailed official publication as to these practices that I am going to inquire about, that are well known and understood by all who come in contact with the taxation of income from oil and gas. Now, that is a vital factor in this case. In this case the government relies strongly on the Comar Oil Company case, as to the East Texas properties, in which case the Court said it had been the consistent practice of the Bureau of Internal Revenue to make the operator of an oil and gas lease include the proceeds from the sale of all royalty oil as a part of his income. Now I want to prove in several ways that that never has been the practice, from the beginning to this date. Here is a man with experience. I think the evidence in the record is sufficient on that. And the evidence will show he comes in close detailed contact for years with officers of the government who are actually taxing income from oil and gas. We want to prove by him, and from other sources, that the statement of the administrative practice, as contained in the Comar Oil Company case, is a mistake. That it never was the practice. Now, if they have any official regulations to rebut that with, they have their experts down on the next floor, and they are at liberty to try to contradict that testimony.

104 The COURT. It is possible it might be what he himself has suffered, or benefited by, might be admissible. But as a general proposition, an executive officer's attitude toward a law is not very forceful save and except for the basis of future legislation. The Congress sometimes is charged with having taken into consideration the method of enforcement and the construction of a statute. What do you think, Mr. District Attorney, to sustaining your objection, save and except allowing the witness to testify as to what his practice—that is, the practice as to him—might have been?

Mr. BACKSTROM. I think that is immaterial, because the question involved here is a question of income. It is a fundamental question of law. It is not like some of the questions that arise out of the intangible questions or things not definite or certain, like allowance of amount of depreciation, and things of that kind, that are largely a question of practice and procedure, which may vary from year to year. In a case of that kind, I think perhaps the long administrative practice of the treasury department has been construed by the Courts, as perhaps of some value, in construing and in determining a doubtful statute; but where we have a fundamental question, which we have here, what is the income of this plaintiff, or whether it is

income or not, it seems to me that the practice of the department, even if definite, would be immaterial, because this is a fundamental question of law. In a very recent case—I cannot call your Honor's attention to the citation right now—where the Supreme Court made such an observation, where it overruled a long practice of the treasury department for fifteen or twenty years, in which the Supreme Court made such observation that this is a fundamental question, and the practice of the department is not material.

105 And I think, Your Honor, for that reason, it would be objectionable. And I think his particular experience would be of little value anyway, because he is one taxpayer out of a vast number, and even the department dealing with Mr. Perkins might not at all represent the general practice in any way, because we know that the Bureau is a vast organization and naturally in such an organization cases are sometimes settled and disposed of, that are inconsistent, even with the general practice of the Bureau. It is impossible to keep them all in consistent harmony with one another. Unless it is a well defined practice through a great number of years, naturally you will have some cases that are settled that might be out of line. I think for that reason that the actual transactions Mr. Perkins has had with the treasury department would be immaterial, because it would not show any consistent policy. I think the statement of the Court in the Comar Oil case is immaterial. It is a fundamental question as to whose income it is. I cannot say what the practice of the Bureau has been with respect to that, whether or not it has been consistent or inconsistent. As I said in this case, it seems to me it is immaterial. The question of whose income, who owned this oil, and that must be construed and determined upon the basic fundamentals of law and the statute, and the general law as to who is the owner of this property.

Mr. WEEKS. May I just add this: that the very fact that the Courts do frequently refer to these administrative practices shows that those practices are frequently material. The question, as I see it, is whether it is a matter of which the Court would take judicial notice—therefore there would be no necessity of proof—or whether it is a matter to be established by evidence. Now, in certain jurisdictions—for instance, the Board of Tax Appeals—very probably the board

106 would take judicial notice of the practice of the Bureau along that line. Frankly I do not know whether the Court feels that it is sufficiently familiar with the actual practice to take judicial notice of it or not. If we do not take evidence on it, we are liable to be confronted with the proposition, the government saying the practice is one thing and I saying it is another. And we have nothing in the record to show which one is right. So far as the materiality is concerned, I don't think it is a good objection, so far as a trial before the Court like this is concerned. I do believe it is very material to show that the practices are contrary, always have been contrary, to the statement of those practices as announced in the case upon which they are going to rely most strongly.

The COURT. I believe what occurred as to others would manifestly be hearsay. And I think we will allow him to say what experience he has had. I give both sides the exceptions.

The WITNESS. In addition to my own individual income tax matters, I have had connection with income taxes of other concerns with which I was interested, with reference to oil and gas, quite a number of partnerships. Cullum & Perkins; Walker & Perkins; Texhoma Oil & Refining Company, the Faith Oil Corporation, and several others; the Belknap Coal Company, the Belknap Oil Company, and others. This experience has been over a period of twenty years. In these matters it has always fallen to my lot personally to handle them with the Bureau of Internal Revenue at Dallas and at Washington—it has always fallen to my lot to handle income tax matters of these companies and partnerships with which I have been associated; some more so than others, but in the main they have all come under
107 my direct supervision, and I have always talked with the revenue agent and gone over the report and the analysis and conferred on all matters. I have been down here a number of times, and in the early days I made a number of trips to Washington, staying there several days at a time and discussing the matter with the income tax authorities for myself and for partnerships. Some of those interests with which I have been connected have been royalty interests and some lease interests. There has not been a year in the last eight or ten years that I have not had as much as eight or ten or fifteen or twenty thousand dollars' royalty interest in addition to what my income may have been from leasehold interests.

Q. Now, Mr. Perkins, in your particular cases, your individual cases, and those that you come in direct contact with, in the manner that you have related; what has been the practice of the Bureau of Internal Revenue, as to whether or not they required a lessee to report as a part of his income, the oil or proceeds of the oil, which went to the lessor as royalty?

Mr. BACKSTROM. We object to that, on the grounds heretofore stated. I think the testimony ought to be confined to specific dealings, rather than practice. I do not think Mr. Perkins' experience has been such as to qualify him to speak as to the general practice. And I think the testimony ought to be confined, if it is going to be admitted, to specific rulings upon specific cases.

The COURT. Well, it is limited to such cases as have come under his personal supervision and control as an executive, or interested person, in these concerns. I overrule the objection.

Mr. BACKSTROM. We except.

108 The WITNESS. We have never reported the royalty from the leasehold interest which we are operating on any lease we have operated, we have never been asked to include the royalty oil and receipts therefrom; and we have never included it because it was, as I understood the practice, and as they were told to me, that was revenue to be reported on by the owner of the royalty and not the lease operator. On the royalty interest I own, I re-

ported it as my income, because I understood it to be the practice of the department that that was required of me, and I reported it and paid for it in every instance. That applies to myself and every company I have been associated with. That has never been changed by the examining officer, on any income tax return I have made for myself or my associates at any time; it has been consistent from 1916, for the last twenty years, down to the present time. They customarily come in and examine very carefully, and usually have a government engineer to check over all of that part of the reports having to do with oil and gas properties, whether it is royalty or whether it is working interest.

Q. What has been your personal experience and observation in those cases like this; if you have had personal experience and observation; take an oil and gas lease which provides, as to the gas, that the lessee is to pay the lessor a fixed sum per well per annum for each well from which gas is sold off of the premises; what has been the practice, in those cases to which we are referring, of the Bureau of Internal Revenue, in regard to that rental or payment per well per annum to the lessor?

A. We have paid the cash rentals, provided in the leases, as a gas royalty, and have charged it up as an expense item and it has been allowed in every instance by the Internal Revenue Department.

Q. In those cases, is it the practice for the lessee to report one hundred percent proceeds from the sale of the gas, where he paid a cash rental——

109 A. Yes, sir, we would report all of the revenues we received from the properties, upon which we would be entitled to depletion.

Q. And deduct the cash rental?

A. As an expense item.

Q. Mr. Perkins, reverting to those Brawley and Branson and Hammond properties in East Texas; did you or not ever sell, or attempt to sell, that portion of the oil applicable to those oil payments to Branson and Hammond and Brawley?

Mr. Backstrom. We object to that. It is immaterial; it encumbers the record, and does not help us in this case at all.

The Court. I do not see the materiality of it.

Mr. Weeks. In the previous trial there was some question made as to the fact that this portion of the oil was his, and that he claimed it. I just wanted to go into that to show that he never attemped to sell it and did not claim it as his own, but always recognized the ownership in Branson and Hammond and Brawley, to that portion of the oil applicable to the oil payment.

The Court. Well, it is a question of law. I do not see any special objection to the question, if you want him to answer it.

A. I have not, because I had nothing whatever to do with it.

The Witness. Would it be permissible for me to state how the Internal Revenue Agent who handled the Branson and Hammond oil payment, in working up cost depletion, handled that

110

matter? I will state that in the calculation of our cost depletion allowance, in respect to this Branson and Hammond property, that the Revenue Agents and the engineers did not treat this $395,000.00 oil payment as a part of the cost of our property, like they treated the cash and notes. In arriving at cost for a given year, they would add to the cash cost of the property only the amount of the oil payment produced in the previous year; so if there had been $30,000.00 produced in 1932 for the oil payment, and the cash cost of the property was $155,000.00, that plus $30,000.00, which would be the basis they would use for establishing cost depletion for the next year and from that they would take the depletion taken in prior years; in other words, they did treat the cash we paid and the notes we paid, as part of our cost, for the purpose of determining cost depletion; but they did not treat any part of the oil payment except that part as had been retired in a previous year; except such part as had been retired in a previous year.

Cross-examination by Mr. BACKSTRON:

Q. ——

A. My income tax returns are reported on the cash receipts and disbursement basis.

J. L. MCMAHON, a witness for the plaintiff, being first duly sworn, examined in chief by Mr. Weeks, testified as follows:

My name is J. L. McMahon. I live in Wichita Falls, and work most of the time in Forth Worth. I am connected with the Texas Company, as Division Manager of the producing—department; my territory is the northern part of Oklahoma, north Texas, west
111 Texas, west central Texas, Arizona, and New Mexico; that includes what we commonly refer to as the Panhandle of Texas, and Moore County. I have been connected with the Texas Company on two occasions, about twenty-one or twenty-two years altogether. The Panhandle territory has been under my supervision since its inception, the first development and prior thereto. My primary duties is the supervision and acquisition of oil properties, purchasing leases, etc. By reason of that connection, it has become necessary for me to acquaint myself with the situation with respect to oil possibilities in this west Texas territory and particularly Moore County, with the values that were being paid from time to time for oil and gas leases and for minerals.

I know the location in Moore County of the properties known as the Ozier Ranch, and the west half thereof, approximately fifty-three hundred acres. I have been acquainted with that territory since the first gas well came in north of Amarillo, which was probably in 1919. At that time that territory was under my supervision for the Texas Company. The west half of the Ozier Ranch territory was valuable, as to the minerals, in January 1924. In my opinion, the fair and reasonable market value of the minerals under the west half of the Ozier Ranch in January 1924, excluding from that

any valuation of the surface, was anywhere from $12.50 to $25.00; that territory looked very attractive about that time from a mineral lease standpoint.

Cross-examination by Mr. POTTER:

I do not know when Mr. Perkins acquired that property. I do not know that Mr. Perkins paid $5.50 per acre for that property; that is, for the mineral and surface rights. If he did pay that price for it, I would still say that the market value was probably
112 $12.50 or $25.00 per acre, because I do not know under what condition Mr. Perkins purchased it, and I would say if he got it at $5.50 that was a very low price.

Offer in evidence

Mr. WEEKS. We offer in evidence certain portions of the deposition of C. H. CLARK, reading as follows:

My name is C. H. Clark. I live in Wichita Falls, and have lived there forty six years. I have been in the oil business since 1912 and am now in that business. I have been trading in oil properties and producing oil and gas. During that period I have operated in Electra, in southern Oklahoma, and later in the Breckenridge country and in the Plains country, west Texas. I have operated what is called the Panhandle section. I was manager of the Red River Oil Company at Electra first, had an interest with them in the property—and also had charge of their property in southern Oklahoma at Healdton; then was president of the Shamrock Oil Company for a good many years, operating in Oklahoma, north of Wichita Falls, and in the Breckenridge country; then later in the Amarillo section, in Hutchinson, Gray, and Wheeler Counties.

My trading in the oil business began in 1912 in the Electra territory, and I bought most of the property that the McMahon Oil Company acquired in that section back in the old days. Then after that I was trading and dealing in oil properties for the McMahon Oil Company until they sold out their properties. Then later on operated as President of the Shamrock Oil Company; then we had a little organization known as the Shamrock Petroleum Company; three of us owned that. The Red River Oil Company was organized at Electra before the McMahon Oil Company came into existence. That was always a separate corporation, and still is; they are practically the same people; they still own that property.
113 I have operated in Moore County, Texas, and in Hutchinson County, and in that section of the Panhandle. I think we went up there about 1919 or 1920; I am not sure about the date right now, because I have not had occasion to look that up—I would say 1919; at least it was several years before 1924, on up through 1924, 1925, and 1926, I operated there at the Shamrock Oil Company and we bought leases and drilled some gas wells, and had quite a little property over that country. We did not produce much oil in that country, however. We traded in leases.

Because of my experience and my work in the Texas Panhandle, and my position, I think I have a general idea of the values of minerals or mineral rights in lands in Moore County during 1924 and 1925. I know the property known as the Ozier Ranch in Moore County; I was over that property shortly after I went up there, I don't know what date, but about 1920. I was over that property and frequently crossed that ranch, going to the well we were drilling. I have a general idea of the value of the property in that territory known as the Ozier Ranch, in January 1924, as to the value of the minerals. Previous to 1924, we leased a block of land from Carry Thompson, which I would say is four or five miles west of the Ozier Ranch. I have a map that will show exactly, but that is approximately correct. Also at the same time we had some leases down southwest of the Ozier Ranch; they came up within two or three miles, probably, I could not say about the distance, because I haven't checked that on the map. I have a map here which shows the Ozier Ranch, and some of this Thompson land is further over here and we had acreage in here; this place here is known as the Masterson Well; the Masterson Oil Company was organized, in which the Shamrock had a half interest, in these properties. The Masterson well was west of the Ozier Ranch about six miles.

114 That well was drilled in 1920. It produced nine million feet of gas. We also drilled a well in section 42, in the Sneed land, which is northwest from the Ozier Ranch about three miles. That well was drilled in 1922, and was a good gas well. I think that was the first well on the Sneed ranch. I believe the first well on the Sneed ranch was drilled in 1921. * * *

I have stated that in my opinion this property, the minerals in this property, had a market value in January, 1924; it is hard to place that in my mind right now, but I will state just now that at that time I would place those mineral rights at $15.00 or $20.00 per acre, in a block of stuff like that, that you could control.

Offer in evidence

Mr. BACKSTROM. We wish to offer the balance of the deposition in evidence, the entire testimony:

I had general charge of those drilling operations, and the acquisition of those leases on those wells which we drilled; I made the trade for the property. We organized the Masterson Oil Company, and as I remember now, it is a little hazy in my mind, that the Shamrock had a half interest in those properties. They organized and put this company at Amarillo, Mr. R. G. Masterson was president.

I had been on the Ozier Ranch, as I remember, Mr. Wells, a friend of mine in Amarillo, and a man in the real estate business, Bill O'Brien, went with me, I think, out on the Ozier Ranch, at one time, to look it over. We were looking the ranch over because it was offered for sale. That must have been around 1922, or some-

where about there. They carried me out there and asked me to check it over and look it over and see it with that in view. I would say that the Ozier Ranch did have prospect and values as to minerals in 1924, because gas was then becoming quite valu-
115 able in that country. There had been wells drilled west of this ranch, and as I remember now, there had been a well drilled east of this ranch, back in that direction. Some gas over here, and it was considered gas territory at that time when I was on it. I went there and looked it over with the idea that we might buy it, and I thought probably that we would, but this Shamrock Oil Company was owned largely by Waxahachie people, Mr. Homer Chapman, said we had better not spend too much money in that country, and I dropped the matter.

I would say that Mr. Perkins bought this ranch in 1924; I will say two years previous to that time, when I was three, that is just an off-hand guess as to the time. * * *

I do not think there was any material difference in the value of the east and west half, for mineral purposes, of the Ozier Ranch in January 1924. This Ozier Ranch was about as rough as there is in all of the country as I remember it. You see, the Canadian River cuts along the south side of the Ozier Ranch and it goes up next to the prairie, then these gulches come in. It is very rough. It is just as rough as you can find in that country. I was looking at it for the mineral rights. I was not caring anything about the surface rights at the time I looked at it. It is purely a ranch proposition, as far as the surface is concerned.

The subsequent course of developments up there established the fact that the Ozier Ranch was productive of gas—it was all productive of gas—so considered in that whole territory. You could get gas wells any place you might drill. Some hard spots you don't get near as much as you do at others, it is indefinite, about the size of the well. I don't know when the first well was drilled upon that land—I don't remember. With reference to this map, as the Ozier Ranch, it showed some drilling having been done on that, and that was done, it was considered proven territory. For instance, there
116 was a well drilled over southeast of that ranch by Jim Whittington at an early date, and that well produced considerable oil, and they developed some good oil in that territory I mentioned; southeast, across the river from the Ozier Ranch. There is a large gas field in the Panhandle of Texas, in Moore County. I think the Panhandle field is classed as about the largest field in the world—that is, this Panhandle gas field. It is about one hundred and sixty miles long, extends from Sayre, Oklahoma, and runs to Dumas in Moore County. I would say it is from ten to thirty miles wide, something over a million acres in it, and about twenty trillion feet of gas, supposed to be. This Ozier ranch is in what is known as the sweet gas area, that is, in the sweet gas area. In this country you get what we call sour gas. I am talking about the territory northwest of the Ozier Ranch, with reference to the sour gas. The sour

gas has greater sulphur content in it, and it is not as good for domestic purposes, where it is used with an open stove. There may be some other chemicals in it, but that is one thing about it, it is not really safe to use in an open stove.

Cross-examination by Mr. BACKSTROM:

I do not remember that I bought any mineral leases, with reference to oil and gas, along about 1924, in the vicinity of the Ozier Ranch. I don't remember that we bought any acreage about that time. You see, this stuff, we got back in 1919 and 1920, some of that was based upon drilling purposes. We took one lease up here that cost us over one hundred thousand dollars, and put down a well on it. Of course, instead of buying the lease we were doing some developing. Here is a general map of the country northeast of the Ozier Ranch. We bought some acreage in there along about 1923 or 1924. It is
117 about five miles northeast. I cannot tell you from this map, but about four or five miles northeast, there is one tract we had there definitely, we thought, I think that was in 1924. We just bought a lease on that land. We did not buy the mineral rights. We were organizing the Shamrock Petroleum Company and we bought that land from Major Reed, a man who had a good deal of property in that country. We paid him $65,000.00 in cash and $65,000.00 in stock in the Shamrock Petroleum Company and we guaranteed that his stock would at least net him par. He would not sell the land outright, and we made him that guarantee, that was about five miles northeast of the Ozier Ranch. That was practically $100.00 per acre for that property. When the Sneed well was being drilled, and we started that well, we sold some of the acreage around that well, and that was in 1922 that this well was finished. We were trying to hedge on it a little bit, if I remember, we sold that stuff from $10.00 to $20.00 per acre. We were getting gas, and we were drilling the Sneed well for both oil and gas, we contemplated at that time building a line into Amarillo and putting the gas in Amarillo. This Sneed well was drilled in 1922. We did not get any oil, but we did get gas. Shortly after that, we sold that property, and I presume that gas is being used from that well at this time in Amarillo, we sold our interest in that property to the Prairie Oil & Gas Company. That was in 1926. I do not know what we got per acre for the mineral rights on that land. I will tell you, there would be a record of it, this Masterson Oil Company, in which some Amarillo people owned an interest, in fact, I went up there and suggested that we put this thing, a separate company from the Shamrock, and we would take our interest in it, half interest, I think that was the way it was. They sold out, though, for considerable money, to the Prairie Oil & Gas Company. What they got, I do not know, but we
118 dropped out of the picture. The Shamrock sold its interest to the Prairie Oil & Gas Company, and the Prairie Oil & Gas Company then bought this interest of the Shamrock, which gave them the whole property. They bought these holdings. I do not

know what we received for the mineral rights on that land; it was included in the general sale. We sold this piece over here. We paid $100.00 per acre for, we sold in 1926 when we sold the property around the Ozier Ranch for mineral purposes. I do not know what the valuation of the property was. We had about eight thousand acres of this land running through here, oil on some of it and gas on some of it, I am sure it was worth a great deal more to the Prairie Oil & Gas than it was to us, from the fact that they built a line to Denver, and have been drawing gas from this territory. That was their object in buying up this property, I think.

After we drilled this well, on the Sneed land, we drilled a well on northwest of this on the Gober land. That was two or three years after this well was drilled down here—after the Sneed well was drilled. That was a gas well, we did not find any oil. I don't remember how much gas it produced, it was what we called a good well, probably twenty or thirty million feet. There was not much sale at that time out there for gas at the well, because there was no way to get it out. The gas, in 1924, had a potential value to the folks that needed it. There was the Prairie Oil & Gas Company getting ready for the line to Denver. Potentially it had a great big value. When you talk about gas land worth $10.00 or $15.00 per acre, that is like getting it for nothing. In fact, this well up here cost, I would say, this well on the Gober cost about $100,000.00 to drill it. They drilled three holes before they got through with it.

It had not been definitely determined in January, 1924, that the Ozier Ranch was not oil land. I cannot refer to those dates exactly, but a well across here, east of that, known as the
119 Whittington well showed considerable oil, I would say that well was six or eight miles east, it was across the Canadian River. Of course, it was presumed—nobody knows—but it was presumed at that time that there was deep oil in the vicinity of the Ozier Ranch. It had a potential value as oil property. I will say this, illustrating our idea about it, because we bought some stuff in here and some other property closer to this Ozier Ranch, but I cannot tell you just where it was, but it was closer in than this McDonald tract, about five or six miles from the Ozier Ranch. I think we bought it in 1924. The only piece I remember, as to the price, definitely, is this 1,280 acres here from Major Reed; also a piece from Will Herring, that we paid about $100.00 per acre for. We paid $100.00, that is, $50.00 cash and a note, half cash and half in a note. Now, if I were at home, I could give you the records and tell you the exact date, but that is approximately correct. This other piece closer up, we paid something like the same price, I would say $100.00 per acre. I would not testify as to the price definitely, because I don't remember, but I remember about this other, because that is definite, my mind is clear. It was impressed upon my mind that Major Reed said he would not lease the land, that he would not sell it, and I went to him with that proposition.

I said, "If you will come in with us on this piece of land, if you will come in and join us on this deal, we will give you half cash and stock for the balance in the Shamrock Petroleum Company." We gave him a positive guarantee that he would get his money back out of the stock. He was a very peculiar fellow to trade with, and a very fine gentleman.

In January, 1924, I looked over the Ozier Ranch with the idea in mind that I might buy this property, but our folks decided that they did not want to put any more money in that territory. I do not know whether we would have paid $15.00 per acre for the
120 mineral rights on the Ozier Ranch or not. I did not recommend to my company the purchase of this Ozier Ranch, we had plenty of acreage up there, and had spent a good deal of money and were spending a good deal more, and we were buying some high priced stuff. I do not know what I could have bought the mineral rights on the Ozier Ranch for at the time I was negotiating for it. After I was on this land it sold very promptly, after I was out on this land. I do know that there was a sale consummated in a very short time. I do not know how they figured the minerals at that time. There was another feature about it, I remember this about it, that it was tied up, there was a mortgage against it, they were swapping horses, trying to save their hide at that time—the detail I do not remember. I cannot place any similarly situated land as the Ozier Ranch in that vicinity where the mineral rights sold for as much as $15.00 or $20.00 around January 1934. There was trading going on all the time. Most of that stuff was worked on that kind of basis. I will show the point, how those values came in; if you got four sections of land, somebody would give you that four sections of land, because they wanted a $25,000.00 or $30,000.00 or $40,000.00 well drilled, and it was very expensive, which made our property cost quite a little money.

I do not know how much gas this Masterson well produced, I think it might have been nine million feet. That seems to be about seven or eight miles from the Ozier Ranch. Nine million feet of gas would be a commercial well. There was no sale for gas out in that territory at that time, because the lines had not come in. We do not buy gas on that basis, if we have a good gas well out there, I can go up there today and show you a gas well that is not selling gas, but it is worth a good deal of money. For instance, we sold a gas well over here about this time, we sold it
for $40,000.00, just as a gas well, and it was producing thirty
121 or forty million feet of gas. We sold it about 1924 or 1925. The Empire built the line in there; I don't know when their line came into that field.

As to why I valued this land at $10.00 or $15.00 per acre, the question comes up in my mind, and you asked me why they did not have a price of more than that, and it is because if you consider now a man gets gas in that territory and you see it now, and you go back and talk about it, and at that price it was picking it up for nothing.

I think the mineral rights on the Ozier Ranch in 1924 could have been sold for as much as $15.00 or $20.00 per acre. If I had been looking for mineral land in that territory, my remembrance is that that would have been a very reasonable, fair price. The conditions since that time has justified that would be getting it for nothing. Because gas land in that territory now is worth—I might state to you gentlemen this—in talking about the value of a gas well, up in this sour gas territory there is not much difference in the value of it now; they figure that a section of land up there might be worth $250,000.00, that is, the gas that is under it. When I state the value as $15.00 or $20.00 of this land in 1924, my memory runs back to that time; if I say that that was a fair price for it, and then if conditions after that time did not justify that statement, then you would say I was really mistaken about my remembrance of the situation back there.

I would consider a value on land as fair that had any prospect and the possibility of giving a man a good return on his investment. I would say the mineral value of that land today would be $50.00 or $75.00 or $100.00 per acre. I will say this, that I contemplated paying for a piece of gas land up there recently $400.00 per acre, and it had oil possibilities and gas possibilities. That is a lease. I am talking about the lease. We did make this kind of a trade recently, one hundred and sixty acres of land on which a well had been drilled,
making about thirty-five million feet of gas, and there is an
122 overriding royalty on that piece of land, and no cash paid for
the lease. The over-riding royalty is one-sixteenth for wells of one hundred barrels or less, and if it gets up about one hundred barrels there is an over-riding one-eighth on it. That is up in this territory, there is some oil being developed around in that territory. It has oil possibilities. The people do not know anything about the value of that gas up there; if they did they would not be wasting a billion feet every day. It is a crying shame to sit around here and let that energy go to waste. There is a proration market up there on that gas. Most of the wells have a market for the gas. They are trying to enforce this proration law. Of course, they have not had much success with it so far, but the major companies now realize that they must prorate that gas out there, and take it out of that field, or they will have serious trouble.

GEORGE H. ABBOTT, a witness for the plaintiff, being first duly sworn, examined in chief by Mr. Weeks, testified as follows:

My name is George H. Abbott. I live in Tulsa, Oklahoma. I am a public accountant, and have been practicing that profession since 1921. I am a certified public accountant in Oklahoma and Arkansas. I am connected with the firm of Barrow, Wade & Guthrie. I supervise all income tax work, federal and state. I have a card that permits me to practice before the Bureau of Internal Revenue, and have been practicing before them since 1921. The major part of my work has to do with the taxation of income from oil and gas. During this

period my work has been in Oklahoma and Texas, from 1921 to date; also in Arkansas.

I am familiar with the practices of the Bureau of Internal
123 Revenue with respect to the taxation of income from oil and gas, and particularly as to royalty owners and lessees; and with the practices which they follow, in determining the income, gross and net income, from those sources. In addition to that, I have had occasion to observe their actual handling of those matters in specific cases.

Q. What has been the nature of your personal experience in those matters; in other words, what has been your opportunities to observe personally their practices in handling those matters?

Mr. BACKSTROM. We object to that as immaterial. It is not the best evidence. The best evidence of the Bureau's practice is its own acts. What it does in cases that are matters of public record, if the plaintiff desires to put that in evidence before the Court, I think Your Honor, that should be presented to the Court, rather than the testimony of some witness as to what has been done.

The COURT. Well, it is the same question I ruled upon a moment ago. I want to be sure that he speaks only of the matters he knows, by actually seeing, and not what somebody told him.

Mr. WEEKS. Mr. Abbott, base all of your answers, entirely upon matters which have come within your direct personal observation and knowledge, matters you have handled and have seen.

Mr. BACKSTROM. We except.

The WITNESS. I either prepare myself or supervise the preparation of federal income tax returns and in the preparation of those
124 returns, we had to be guided, as to our opinion, as to the requirement of the law and the regulations; following the examination by revenue agents, with whom I may have had frequent conferences. We also have conferences with the Internal Revenue Agent in Charge, or conferences with his representatives. We also have conferences in Washington, and in some cases we file appeals to the Board of Tax Appeals, and have tried cases there in which I have been co-counsel, or counsel of record. I have done all of those things myself. I handle from twelve to twenty cases each year.

Mr. POTTER. We object to this line of testimony.

Q. Tell us this, Mr. Abbott, as you have observed actually by experience and practice in this work, what has been the practice of the Bureau of Internal Revenue in those cases which you observed as to whether or not they required the lessee under an oil and gas lease to report as a part of his income, the oil and gas which went to the lessor or royalty owner, or the money which went from the sale of that oil or gas to the lessor or royalty owner.

The COURT. Now, before he answers that, they wish an exception.

Mr. BACKSTROM. We renew our objection to this specific question.

The COURT. Let the exception be noted.

The WITNESS. As far as my observation and knowledge goes, the commissioner has never required the lessee to include in his taxable income the royalty received by the lessor.

I have never had occasion to observe the practice in case of gas wells where there was a flat rental per year for the production of gas from the wells. I have had occasion to observe, on several occasions, the practice with respect to oil payments.

Q. What has been the practice of the Bureau of Internal Revenue, as you have observed it, in those cases in which an oil and gas lease was transferred—let us say for a cash consideration—but the assignor reserves a certain fraction of the oil until that oil produced so much money, let us say one-fourth of seven-eighths, until the assignor got $100,000.00; where there was an express reservation in the assignment, what has been the practice of the bureau in those cases, that you observed, as to whether or not that one-fourth of seven-eighths was treated as the income of the assignor or the assignee?

Mr. BACKSTROM. We object to that.

The COURT. Overrule the objection.

Mr. BACKSTROM. We except.

The WITNESS. I don't know that I ever recall having a case in which the assignment made a specific reservation, that is where the term "reserved" or "reservation" was used. I don't think I have not had occasion to deal with a lease where it said "except one-fourth" until any specific amount has been paid.

Q. Do you know what the practice is, from your general experience, in handling tax matters, as to the way they treat such a situation?

Mr. BACKSTROM. We object to that.

The COURT. Sustain the objection.

Mr. BACKSTROM. We except.

The COURT. I want to ask you a question. You answer so far as you know. What do you mean by that reservation?

The WITNESS. In what question was that, Judge Atwell?

Mr. WEEKS. It was the question as to what the Commissioner's practices were?

The WITNESS. Well, I was just trying to stay within the ruling of the Court, that I am limited here to what I, myself, have seen.

The COURT. That is what you mean?

The WITNESS. Yes, sir.

I do not know of any case, in my experience, where they held otherwise.

J. J. PERKINS, recalled, examined in chief by Mr. Weeks, testified as follows:

When I was on the stand awhile ago, there was perhaps some confusion as to the question of whether or not I had been allowed depletion in my 1928 return in respect to the bonus on this oil and gas lease. Since I left the stand, I have checked into that, and I find that we were not allowed any depletion. We were allowed neither depletion nor any part of the cost for 1928, the entire cash bonus was reported, and the revenue agents checked up, as income.

Plaintiffs Rest.

Statement by Mr. Backstrom

Mr. BACKSTROM. In the answer which was filed to the amended petition the defendant has made an alternative allegation that one fourth of the cost of producing the oil from these leases should be disallowed as operating expense in the event that the Court holds that one fourth of the income, the income in question here, should be eliminated from the plaintiffs' taxable income. So we take the position that if that income is not included that one fourth of the cost of producing it, which has been allowed as a deduction, would be disallowed. In the return, as the record shows, they were allowed, as cost of producing the oil, $17,384.00, and we have claimed one fourth of that should be disallowed, which would be $4,346.21. I would like, in order to show what was allowed as a cost of producing this oil as the expense, we introduce in evidence the revenue agent's report, which set up the additional tax, which is being sued to be recovered, and with specific reference to Schedules 1, 1a, item 18 and C, and Schedule 3, and exhibits D, D1, and D-2.

Colloquy

Mr. WEEKS. We have no objection to the introduction of the data to which he has referred, but I think his offer should be limited to that, because the report contains a lot of figures.

The COURT. Well, you cannot make an agreement with him?

Mr. BACKSTROM. If Mr. Weeks will agree that the plaintiff was allowed as a deduction, in taking out all the oil from these
128 leases which were involved in this question, the sum of $17,-384.85, and that we allowed that amount as a part of Mr. Perkins' operating expense for the year in determining the net taxable income, I think that would take care of all we wish to prove by this offer.

The COURT. I think you are entitled to one or the other under your pleadings.

Mr. WEEKS. We think this Exhibit D shows all of the data necessary.

Mr. BACKSTROM. It does not show the computation. There might be some question about it being carried forward.

Mr. WEEKS. I will say that I am willing to agree. We agree that in determining these plaintiffs' net income they were allowed to deduct the amount of the cost of operating the east Texas leases actually paid in that year. These costs cover not only the cost of the production of the share of the oil which went to them, but the share of the oil which went to the royalty owners and to the holders of the oil payments—. This Exhibit D-2 correctly reflects the calculation made by the commissioner and carried into his final calculation of

tax liability, showing the amount of expenses which he allowed to Mr. and Mrs. Perkins and to their co-operator, Green.

Mr. BACKSTROM. We will accept that statement. Also the exhibit D–2 be introduced rather than Exhibit D–1.

Mr. WEEKS. That is satisfactory.

(Said instrument marked "Plaintiff's Exhibit B" and reading as follows:)

129 *Exhibit B*

In re: J. J. Perkins et ux. Exhibit D–2

Perkins and Green—East Texas Properties

Allowable Depletion

	Barrett & Wencker lease	Fenton lease	Fuller lease	Brawley lease	Total
All sales per return	$18,589.10	$13,510.67	$13,860.65	$3,063.41	$49,023.83
Payments out of oil	7,354.31	5,360.09	5,500.98	1,013.65	19,229.03
	25,943.41	18,870.76	19,361.33	4,077.06	68,252.56
Deductions—					
Operating expense including overhead, taxes, and insurance	8,998.67	7,307.33	8,974.44	2,204.42	27,484.86
Depreciation	2,611.20	1,835.73	1,976.22	861.69	7,284.84
Total deductions	11,609.87	9,143.06	10,950.66	3,066.11	34,769.70
Net before depletion	14,333.54	9,727.70	8,410.67	1,010.95	33,482.86
50% of net	7,166.77	4,863.85	4,205.34	505.47	16,741.43
27½% of oil sales	7,134.44	5,189.46	5,324.36	1,121.19	18,769.45
Cost depletion	2,503.49	3,544.59	4,170.43	6,222.33	16,440.74
Allowable depletion	7,134.44	4,863.85	4,205.34	6,222.33	22,425.96
Depletion claimed	4,286.10	9,465.33	8,648.56	6,108.31	28,508.29
Increase (decrease)	2,848.34	(4,601.48)	(4,443.21)	114.02	(6,082.33)

A. H. FREEMAN,
Internal Revenue.

Approved August 31, 1935.

(Signed) ALEXANDER D. BELL,
Engineer Revenue Agent.

Approved:

L. P. ANDERSON,
Chief, Natural Resources,
Section: _____

131 J. J. PERKINS, recalled, examined in chief by Mr. Backstrom, testified as follows:

I am reasonably familiar with the operations of these leases which are shown in Exhibit D–2. I do not think I could explain what items are covered by operating expenses, which were allowed with respect to those leases for the year 1933; it is a matter of record on my books. I could check it up if I had an opportunity to do so, but that is a matter of detail handled through the office. As to the

operations covered by those expenses, you have here an item of operating expense, including the overhead, taxes, and insurance. That would include the lease men, and minor repairs, and it would include ad valorem taxes, compensation insurance, superintendents salary, allocated to those properties, and I think it would include the office expense; however, that was only $50.00 per month, as I recall it. I know that we paid a large amount of interest on money that we owed in connection with the operation and development of these properties, and I think that the interest was included in this, not necessarily an expense item, but it was money we owed in connection with the properties, one way or the other. I imagine it was included in that item. The items included in the expense here would represent more than the cost of taking the oil out of the ground, it would represent the interest items, which was not part of the expense of producing the oil. Leaving out the interest item, I would say the expense items all represent the cost of taking the entire oil from these leases, that is in the main, with reference to the details, I could not say exactly, but that is approximately correct. This is evidently the amount that the revenue agent allowed as being the amount. The presumption is that that would represent the cost of taking the oil out of those leases, and that would also include the item of interest. I would assume that this item of $27,000.00
132 includes all of the cost of taking out the oil and interest items, and those are the only items I would know it included, because I have no detailed check on it.

Colloquy

Mr. BACKSTROM. I renew my offer of the Revenue Agent's report as to the schedules 1, 1a, item 18 and C, and Schedule 3, and Exhibit D, D1, D2.

Your Honor, the schedule, as I see it, that is in evidence, does not exactly show just exactly what I think we ought to show was allowed, and for that reason, in view of the testimony of Mr. Perkins, I would offer this for the purpose of showing what we allowed.

The COURT. I thought we had passed that. You wanted to show that $17,384.85 had been allowed by the government in this particular transaction?

Mr. BACKSTROM. Yes.

The COURT. And $4,000 and some odd dollars was this taxpayer's part of it?

Mr. BACKSTROM. Yes.

The COURT. I asked Mr. Weeks if he would agree to it, and I understood him to say that he agreed to what he did say in the record, and to schedule D-2. Doesn't that furnish what you want?

Mr. BACKSTROM. I don't think it does.

133 The COURT. Is there any objection to these figures that he has in mind?

Mr. Weeks. The figures are all right. We have no objection to the Revenue Agent's report going in, because I am sure Mr. Backstrom will agree to eliminate any immaterial portions. The purpose was to keep from encumbering the record.

The Court. Have you any objection to these figures?

Mr. Weeks. This exhibit shows overhead, operating expense, including overhead, taxes, insurance, $27,484.86, depreciation on physical equipment of $7,284.84, total of $34,769.70. That is for the Perkins and Green interest together; in other words, it is the operating expense, overhead, taxes, and insurance for 1933, plus depreciation. The government's position is that if we exclude from income one fourth of seven eighths of the oil then we should exclude one-fourth of the operating expenses. We are willing to agree that these figures were allowed us in computing our taxable income.

The Court. But you do not have the figures that he wants.

Mr. Backstrom. One-half of that went to Perkins.

The Court. You have figured thirty-four thousand dollars, plus, now he does not say thirty-four thousand dollars plus, he says seventeen thousand three hundred eighty four ($17,384.85) dollars, eighty-five cents, then one fourth of that.

134 Mr. Weeks. Yes.

The Court. That is what he wants you to say, that this is correct, if you will agree to that.

Mr. Weeks. Yes; I think that is all right. I will develop it by cross examination.

The Court. I do not like to transgress this secret process that the taxpayer has the benefit of, unless we have to do it. I am not sure that a Court could do it in a civil proceeding. Of course, I am sure it could be done in a criminal proceeding. That is the only reason I see here.

Mr. Weeks. I did not think of that, but certainly the Revenue Agent's Report is a detailed reflection of all of a man's financial affairs that no one has any particular business with.

The Witness. The oil from the leases shown on Exhibit 2, was taken out by myself and my associates. The oil represented the one-fourth involved in this controversy here, was taken out and the cost of that was included in the total cost shown on Exhibit D-2.

Examination by Mr. Weeks:

The item on the schedule D-2, Defendant's Exhibit B, $7,284.84, goes to make up the total of $34,769.70, half of which is applicable to me, that represented the depreciation on the physical equip-

135 ment to be placed on the lease, the derrick, casing, tanks, tubing and other things. That belonged to me and my associates. When I say myself and associates, I mean the Faith Oil Company, and Mr. Green. These expenses, operating expenses, include overhead, taxes, and insurance actually paid by myself and Mr. Green and the Faith Oil Corporation. We are not going to get anything back from Bronson or Hammond or anybody else, there is no way

by which I am going to recoup any of these expenses I have paid out.

Defendant rests.

Mr. WEEKS. The defendant has raised some question about the refund claim on a small portion of this. We want to offer in evidence the refund claim filed by Mr. Perkins, with the understanding that it is stipulated that the other refund claim filed by Mrs. Perkins is identical.

Mr. BACKSTROM. It is agreed to.

(Said instrument introduced, marked "Exhibit C" and reading as follows:)

Exhibit 6

JAN. 10, 1936.

IT:C:CC-4-CCP.

In re: Claim for refund of $1,442.07 for the year 1933

Mr. J. J. PERKINS,
Postoffice Box 1470,
Wichita Falls, Texas.

SIR: Reference is made to Bureau letter dated December 16,
136 1935, wherein you were informed that the claim for refund indicated above would be disallowed. The letter also stated the reasons for the proposed disallowance.

The claim having been disallowed or rejected on Schedule numbered 22535, this notice of disallowance is sent to you by registered mail as required by Section 1103 (a) of the Revenue Act of 1932.

Respectfully,

GUY T. HELVERING,
Commissioner,
(Signed) By CHAS. T. RUSSEL,
Deputy Commissioner.

ib
IT:AR:E-1.

NF (Stamped) Received Dec. 18, 1935, Claims Control Section. Dec. 16, 1935.

"Omitted because identical with Plaintiffs' Exhibit A, as per stipulation of counsel copied at page one hereof.

* * * * * * *

Exhibit

Statement attached to the Claims for Refund of Income Taxes paid for the Calendar Year 1933 by J. J. Perkins and Wife, Mrs. J. J. (Lois) Perkins, Wichita Falls, Texas, P. O. Box 1470.

Under date of October 15, 1935, there was transmitted to the above named claimants the report of Internal Revenue Agent A. H. Freemon, with respect to the tax liability of the above named for

the calendar year 1933. This report is dated September 17, 1935. This report is hereby referred to and made a part hereof for all purposes.

The additional taxes shown by said report were paid to the
137 Collector of Internal Revenue at Dallas, Texas, on October 24, 1935. The payments made were as follows:

J. J. Perkins—additional income:	
Tax	$1,315.37
Interest thereon	125.70
Total	$1,442.07
Mrs. J. J. Perkins—additional:	
Income tax	$1,316.37
Accrued interest	125.70
Total	$1,442.07

The taxpayers had theretofore paid for the calendar year 1933, in regular quarterly installments in 1934, the following sums as income taxes for the year 1933:

J. J. Perkins	$3,070.14
Mrs. J. J. Perkins	$3,102.14

The taxpayers seek the refund of all of the taxes paid on October 24, 1935, with the interest paid thereon, or such greater or lesser amounts as may be refundable because of the facts hereinafter set forth.

Among other changes made in said Revenue Agent's report were adjustments on oil reserves in respect to oil properties in East Texas in which these taxpayers have an interest.

The taxpayers do not agree to this adjustment. They believe it is incorrect and that the reserves as adjusted are materially excessive. Because, however, of the application of percentage depletion to these properties, it appears from the taxpayers' calculations that this adjustment does not increase their tax liability for the year 1933.

If, however, it should develop upon consideration of this claim
138 for refund, or any subsequent proceeding based thereon, that the determination of cost depletion is necessary to arrive at their taxable income, then the taxpayers say that said reserves as adjusted in said Revenue Agent's report are materially excessive.

In the year 1933 these taxpayers owned a 3/8ths interest in such leasehold rights to oil and gas leases in Texas as were granted by an assignment and conveyance executed on July 24, 1931, by Mamie S. Hammonds, O. O. Hammonds, and Fred P. Branson to Faith Oil Corporation. A copy of this conveyance is attached hereto and made a part hereof, but there is omitted from said copy the detailed description of the various tracts of land covered by said assignments as such descriptions are not material to a consideration of the questions here presented. Another 3/8ths of such interest was owned by W. J. Green and 1/4th was owned by the Faith Oil Corporation.

Said assignment provided for what is commonly referred to as the "oil payment" in the sum of $395,000.00; said instrument providing,

in substance, that a certain percentage of the oil produced from the properties covered by said conveyance was to go to the assignors above mentioned until they had received from this source oil of the value of $395,000.00. Said payment being entirely contingent upon the production of enough oil from said property so that the specified percentage would produce for said assignors the sum above mentioned.

In the year 1933 the above named assignors received oil of the value of $19,229.03 by virtue of so much of the oil payment as was applicable to the percentage of interest in said property owned by these taxpayers and W. J. Green.

The examining officer has included said sum as income derived by Perkins and Green from their joint operations. (See Exhibit D, page 14 of said Revenue Agent's report.) This increases the alleged gross income of the taxpayers from these operations by one
139 half of said sum. Taxpayers say that this sum is not their income, but that the oil from which this income was derived and the proceeds from the sale of said oil were in truth and in practical effect, as well as in law, the income and property of the said assignors, and that this sum should be excluded from the computation of their income.

Claimants admit that by said report depletion was allowed with respect to said sum and that, if their position is maintained, it will be necessary to recalculate depletion on that account.

In the year 1933 the taxpayers sold their interest in all of the minerals underlying the Ozier Ranch in Moore County, Texas. They reported a capital gain from this source of $23,573.33 (See 5th Item, Schedule 4, page 7 of said Revenue Agent's report). This was increased by the Revenue Agent by the sum of $7,500.00, and to this increase taxpayers protest and claim a refund of so much of the tax paid as was based thereon.

The taxpayers acquired an undivided 1/3rd interest in this ranch in 1924 at a cost of $10,000.00. The ranch contained 5,400 acres. At the time this ranch was acquired by the taxpayers and associates, the mineral content thereof was its principal element of value. The taxpayers would not have considered purchasing said land but for this mineral value. In their opinion, then and now, at least 3/4ths of the cost and value when purchased was attributable to this mineral value. Because of this, they say that when, in 1933, they sold and conveyed all of their interest in these minerals they were entitled to deduct, in arriving at their taxable income therefrom, so much of the cost thereof as was attributable to the mineral value; that this was at least $7,500.00, and that the Revenue Agent erred in disregarding this cost in determining their taxable income. In the alternative, the taxpayers say that they are entitled to depletion upon all of the consideration received for the minerals sold.

140 "Omitted because identical with Plaintiffs' Exhibit 1", as per stipulation of counsel copied at page one hereof.

* * * * * * *

Exhibit

CLAIM

To be filed with the collector where assessment was made or tax paid

The collector will indicate in the block below the kind of claim filed, and fill in the certificate on the reverse side.

(Collector's Stamp.) (Dated received ----------)

(x) Refund of tax illegally collected.

( ) Refund of amount paid for stamps unused, or used in error or excess.

( ) Abatement of tax assessed (not applicable to estate or income taxes).

(Stamped): Received Dec. 9, 1935. Claims Control Section.

STATE OF TEXAS,
County of Wichita, ss:

Name of Taxpayer or purchaser of stamps (type or print), J. J. Perkins. Business address, Box 1470, Wichita Falls, Texas. Residence, 3301 Harrison Blvd., Wichita Falls, Texas.

The deponent, being duly sworn according to law, deposes and says that this statement is made on behalf of the taxpayer named, and that the facts given below are true and complete:

1. District in which return (if any) was filed, Dallas, Texas.

141 2. Period (if for income tax, make separate form for each taxable year) from 12-31, 1932, to 12-31, 1933.

3. Character of assessment of tax, Income taxes.

4. Amount of assessment, $--------; dates of payment—See statement attached.

5. Date stamps were purchased from the government----------

6. Amount to be refunded including interest paid, or such greater or lesser amount as may be legally refundable, $1,442.07.

7. Amount to be abated (not applicable to income or estate taxes $----------).

8. The time within which this claim may be legally filed expires, under Section 322 of the Revenue Act of 1932, after October 24, 1937.

The deponent verily believes that this claim should be allowed for the following reasons:

See Statement attached.

(Stamped) Bureau of Internal Revenue Mail Room. 1935. Dec. 9 AM. 947.

(Signed) J. J. PERKINS.

Sworn to and subscribed before me this 7th day of November 1935.

[SEAL] S. A. MAN, *Notary Public.*

(See instructions on Reverse Side.)

Certificate

I hereby certify that an examination of the records of this office shows the following facts as to the assessment and payment of the tax:

142

Character of assessment and period covered	List	Year	Month	Account page	No. or line	Amount assessed	Paid; abated; or credited		Pd. Ab. Cr.
							Date	Amount	
1933	IT	1934		214856		$3,070.14	4-14-34	$746.25	Pd.
						3.78	6-14-34	792.60	"
				Into Acct. 9-B			3-15-34	25.00	"
							9-14-34	755.04	"
							12-15-34	755.03	"
1933 Add'l	193-IT	1935	Oct.	510082		1,316.37	10-25-35	1,442.07	"
						125.70			
					Total	4,515.99	Total	4,515.99	

I certify that the records of this office show the following facts as to the purchase of stamps:

To whom sold or issued	Kind	Number	Denomination	Date of sale or issue	Amount	If special tax stamp, state:	
						Serial No.	Period commencing

Rejected 22535. I. T. Schedule

Claim examined by NF Amount claimed, $1,442.07.
Claim approved by ---------- Amount allowed, $---------
Chief of Division. Amount rejected, $1,442.07.

(Signed) W. A. THOMAS,
Texas 2nd,
Collector of Internal Revenue Dist. B. B.

Committee on Claims

143

Instructions

1. The claim must set forth in detail and under oath each ground upon which it is made, and facts sufficient to apprise the Commissioner of the exact basis thereof.

2. Claim should be sworn to by the taxpayer, if possible. Whenever it is necessary to have the claim executed by an attorney or

agent, on behalf of the taxpayer, an authenticated copy of the document specifically authorizing such agent or attorney to sign the claim on behalf of the taxpayer shall accompany the claim. The oath will be administered without charge by any collector, deputy collector, or internal revenue agent.

3. If a return is filed by an individual and a refund claim is thereafter filed by a legal representative of the deceased, certified copies of the letters testamentary, letter of administration, or other similar evidence must be annexed to claim, to show the authority of the executor, administrator, or other fiduciary by whom the claim is filed. If an executor, administrator, guardian, trustee, receiver, or other fiduciary files a return and thereafter refund claim is filed by the same fiduciary, documentary evidence to establish the legal authority of the fiduciary need not accompany the claim, provided a statement is made on the claim showing that the return was filed by the fiduciary and that the latter is still acting.

4. Where the taxpayer is a corporation, the claim shall be signed with the corporate name, followed by the signature and title of the officer having authority to sign for the corporation.

144

IV

Thereupon the testimony was concluded and both parties closed, and each party presented to the Court a Motion for judgment in favor of such party and, after argument, the Court granted the Plaintiffs' Motion for Judgment in part and denied the same in part, and granted Defendant's Motion for Judgment in part and denied the same in part.

V

Wherefore, the Plaintiffs pray that this, their Bill of Exceptions, may be allowed, settled, and signed.

HARRY C. WEEKS,
Attorney for Plaintiffs,
J. J. Perkins and Mrs. Lois Perkins.
Staley Building, Wichita Falls, Texas.

It is agreed by and between the counsel for the respective parties that the above and foregoing is a full, true, and correct statement of the proceedings had upon the hearing of the above numbered and entitled cause, and of the evidence adduced thereat, and that the same shall constitute the Bill of Exceptions on appeal with reference to such matters as herein stated.

HARRY C. WEEKS,
Attorney for Plaintiffs.
CLYDE O. EASTUS,
FRANK B. POTTER,
J. L. BACKSTROM,
Attorneys for Defendant.

Order approving bill of exceptions

The above and foregoing, having been agreed to by counsel for the respective parties hereto, is hereby approved and ordered
145 filed as a part of the record in this cause as the Bill of Exceptions, which shows a full, true, and correct statement of the proceedings had upon the trial of the above styled and numbered cause, and a full, true, and correct statement of the evidence adduced thereat.

Dated this the 7th day of July, A. D. 1936.

WM. H. ATWELL,
United States District Judge.

In United States District Court

Petition for appeal and order allowing same

Filed July 6, 1936

To the Honorable Wm. H. Atwell, Judge of said Court:

The above named plaintiffs, J. J. Perkins and wife, Mrs. Lois Perkins, feeling themselves aggrieved by judgment made and entered in this cause on the 11th day of June, 1936, do hereby appeal from the said judgment to the United States Circuit Court of Appeals for the Fifth Circuit for the reasons set forth in the Assignment of errors which is filed herewith.

Wherefore, premises considered, your Petitioners pray that their appeal be allowed; that citation issue as provided by law, and that a transcript of the record, proceedings and papers upon which said judgment was based, duly authenticated, be sent to the United States Circuit Court of Appeals for the Fifth Circuit sitting at New Orleans for the correction of the errors complained of and herewith assigned, and that the proper order touching the security to be required of them to perfect their appeal be made.

(Signed) HARRY C. WEEKS,
WEEKS & MORROW,
Attorneys for Plaintiffs.

146 *Order*

The foregoing petition for appeal is this day granted and the appeal allowed, conditioned upon the Plaintiffs giving bond for costs, as required by law, in the sum of Five Hundred ($500.00) Dollars.

Dated the 6th day of July, 1936.

(Signed) WM. H. ATWELL,
United States District Judge.

In United States District Court

Assignment of errors

Filed July 6, 1936

Now come the Plaintiffs and file this their Assignment of Errors as a basis for their appeal from the judgment herein rendered against them (in so far as it relates to the matters covered by the following Assignment of Errors) on the 11th day of June, 1936, and say that the same is erroneous and unjust to the Plaintiffs, in this:

I

The Court erred in denying Plaintiffs' motion for judgment, in so far as the same related to the inclusion in the Plaintiffs' taxable incomes, for the year 1933, of any portion of the oil (or the proceeds from the sole thereof) produced from the oil and gas leases described in the assignment from Branson and Hammonds to Faith Oil Corporation, which went to Branson and Hammonds under the rights and titles retained by them (Branson and Hammonds) in said assignment to have delivered to them one-fourth (¼th)
147 of the oil produced and saved therefrom until they had received $395,000.00, or oil of that value; and in failing to award Plaintiffs a recovery of so much of the income taxes and interest paid by them for the year 1933, as was based upon the inclusion of any of the aforesaid amount as a part of their taxable income for the year 1933.

II

The Court erred in holding that so much of the income taxes and interest collected by defendant from Plaintiffs for the year 1933, as was based upon including, as a part of the Plaintiffs' taxable incomes for 1933, the proceeds from the sale of so much of the oil produced in 1933 from the properties described in the assignment to Faith Oil Corporation from Branson and Hammonds as went to said Branson and Hammonds under the rights and titles retained by said Branson and Hammonds in said assignment to have delivered to them one-fourth (¼th) of the oil produced and saved from said properties until they, the said Bransom and Hammonds had received $395,000, was properly assessed and collected, and in failing and refusing to allow Plaintiffs a recovery of such taxes and interest.

III

Since the undisputed evidence in this case showed the following facts:

(1) That Branson and Hammonds retained, in the assignment which they made to Faith Oil Corporation, the right to have deliv-

ered to them one-fourth (¼) of all of the oil produced from the properties described in said assignment until they had received $395,000.00;

148 (2) That the Plaintiffs acquired as their community property, prior to 1933, and held throughout 1933, three-eighths (⅜ths) undivided interest in such rights, titles, and estates to the properties there described as were originally assigned by Branson and Hammonds to Faith Oil Corporation, and held same subject to the aforesaid right of Branson and Hammonds;

(3) That oil was produced from said properties in 1933 and one-fourth (¼th) thereof delivered to the pipe lines serving said properties to the credit of Branson and Hammonds, and that said one-fourth (¼th) was sold by Branson and Hammonds to various oil purchasing concerns who paid Branson and Hammonds directly for the same, and that no part of the proceeds from the sale of said one-fourth (¼th) of the said oil produced in 1933 was ever received by Plaintiffs;

(4) That the total amount received by Branson and Hammonds from the sale of said one-fourth (¼th) of the oil produced in 1933, was $24,287.10, and that there was included in the final determination and assessment of the Plaintiffs' income tax liabilities for 1933, three-eighths (⅜ths) of said sum, to wit, $9,107.69, and that a portion of the income taxes, and interest, collected by defendant from Plaintiffs, on October 25, 1935, was attributable to the inclusion of said sum as a part of the plaintiffs' taxable incomes;

(5) That Plaintiffs had duly filed claims for the refunding of said taxes and interest; that said claims had been rejected, and that Plaintiffs were authorized to maintain this suit for the recovery of such taxes and interest;

The Court erred in denying Plaintiffs a recovery of such taxes and interest, and in holding that said sum of $9,107.69 was properly included as a part of their taxable income for the year 1933.

149 IV

The Court erred in denying Plaintiffs' motion for judgment, in so far as the same related to the inclusion in the Plaintiffs' taxable incomes, for the year 1933, any portion of the oil (or the proceeds from the sale thereof) produced from the property described in the oil and gas lease from E. H. Brawley and wife, Cora Brawley, to W. J. Green, which went to E. H. Brawley under the rights and titles retained by him in said oil and gas lease to have delivered to him one-fourth (¼th) of seven-eighths (7/8ths) of the oil produced and saved therefrom until he had received Forty-Five Thousand ($45,000.00) Dollars, or oil of that value, and in failing to award Plaintiffs a recovery of so much of the income taxes and interest paid by them, for the year 1933, as was based upon the inclusion of any of the aforesaid amount as a part of their taxable incomes for the year 1933.

V

The Court erred in holding that so much of the income taxes and interest collected by defendant from Plaintiffs, for the year 1933, as was based upon including as a part of the Plaintiffs' taxable income, for 1933, the proceeds from the sale of so much of the oil produced in 1933 from the property described in the oil and gas lease from E. H. Brawley and wife to W. J. Green, as went to said E. H. Brawley under the rights and titles retained by him in said oil and gas lease to have delivered to him one-fourth (¼th) of the oil produced and saved from said property until he, the said Brawley, had received Forty-Five Thousand ($45,000) Dollars, was properly assessed and collected, and in failing and refusing to allow Plaintiffs a recovery of such taxes and interest.

150 VI

Since the undisputed evidence in this case showed the following facts:

(1) That E. H. Brawley retained, in the oil and gas lease which he and his wife made to W. J. Green, the right to have delivered to him one-fourth (¼th) of seven-eighths (7/8ths) of all of the oil produced from the property described in said oil and gas lease until he had received Forty-Five Thousand ($45,000.00) Dollars;

(2) That the Plaintiffs acquired as their community property, prior to 1933 and held throughout 1933, three-eights (3/8ths) undivided interest in such rights, titles, and estates to the properties there described as were originally leased by E. H. Brawley and wife to W. J. Green and held same subject to the aforesaid right of E. H. Brawley;

(3) That oil was produced from said property in 1933 and one-fourth (1/4th) of seven-eighths (7/8ths) thereof delivered to the pipe lines serving said property to the credit of E. H. Brawley, and that said one-fourth (1/4th) of seven-eighths (7/8ths) was sold by E. H. Brawley to various oil purchasing concerns, who paid him directly for the same, and that no part of the proceeds of the sale of said one-fourth (¼th) of seven-eighths (7/8ths) of the said oil produced in 1933 was ever received by Plaintiffs;

(4) That the total amount received by E. H. Brawley from the sale of one-fourth (¼th) of seven-eighths (7/8ths) of the oil produced therefrom, in 1933, was $1,351.53, and that there was included, in the final determination and assessment of the Plaintiffs' income tax liabilities for the year 1933, three-eighths (3/8ths) of said sum, to-wit, $506.83, and that a portion of the income
151 taxes and interest collected by defendant from Plaintiffs on October 25, 1935, was attributable to the inclusion of said sum as a part of the Plaintiffs' taxable incomes;

(5) That Plaintiffs had duly filed claims for the refunding of said taxes and interest; that said claims had been rejected, and that

Plaintiffs were authorized to maintain this suit for the recovery of such taxes and interest;

The Court erred in denying Plaintiffs a recovery of such taxes and interest and in holding that said sum of $506.83 was properly included as a part of their taxable incomes for the year 1933.

VII

The Court erred in limiting Plaintiffs' recovery of costs to such costs as were incurred with respect to the issue as to which Plaintiffs prevailed, and in not allowing Plaintiffs to recover from defendant all costs in this behalf incurred.

Wherefore, Plaintiffs pray that the judgment be reversed and that the United States Circuit Court of Appeals for the Fifth Circuit grant such relief as the nature of the case demands.

(Signed) HARRY C. WEEKS,
WEEKS & MORROW,
Attorneys for Plaintiffs, J. J. Perkins and Mrs. Lois Perkins.

[Bond on appeal for $500.00 approved and filed July 6, 1936, omitted in printing.]

153 [Citation in usual form showing service on Clyde O. Eastus et al., filed July 7, 1936, omitted in printing.]

154 In United States District Court

Praecipe for transcript of record

Filed July 7, 1936

To the Clerk of the District Court of the United States for the Northern District of Texas, Dallas, Texas:

SIR: You will please include in the transcript of the record for the appeal in the above entitled cause the following papers, proceedings, and documents:

1. Plaintiffs' First Amended Original Petition.
2. Defendant's First Amended Original Answer.

155 3. Plaintiffs' Motion for Judgment filed June 11, 1936.
4. Defendant's Motion for Judgment filed June 11, 1936.
5. Judgment of the Court.
6. The Opinion of the Court Delivered June 11, 1936.
6-a. Application for Extension of Time and Order Thereon.
7. Plaintiffs' Bill of Exceptions.
8. Application for Appeal and Order Allowing same.
9. Assignment of Errors.
10. Appeal Bond and its Approval.
11. Citation on Appeal and Acknowledgment of Service Thereof.
12. This Praecipe and Proof of Service Thereof.

(Signed) HARRY C. WEEKS,
WEEKS AND MORROW.
Attorney for J. J. Perkins and Mrs. Lois Perkins.

156 It is agreed between counsel for the respective parties in the above cause that the foregoing papers, proceedings, and documents constitute a complete record on appeal in said cause.

Executed this 7 day of July 1936.

(Signed) HARRY C. WEEKS,
Attorney for J. J. Perkins and Mrs. Lois Perkins.
(Signed) CLYDE O. EASTUS,
(Signed) FRANK B. POTTER,
(Signed) J. L. BACKSTROM,
Attorneys for W. A. Thomas, Collector of Internal Revenue for the Second District of Texas.

157 [Clerk's Certificate to foregoing transcript omitted in printing.]

158–160 [Omitted.]

161 [Caption omitted.]

162 In United States District Court

Defendant's application for extension of time

Filed June 26, 1936

Comes now the defendant by Clyde O. Eastus, United States Attorney, and Frank B. Potter, Assistant United States Attorney, and moves the Court that the present term of this Court be continued as to this cause for a period of 75 days so that the defendant may prepare and have settled such statement of evidence, bill of exceptions, and other matters as the defendant may deem necessary and proper.

(S.) CLYDE O. EASTUS,
United States Attorney.
(S.) FRANK B. POTTER,
Assistant United States Attorney.

163 In United States District Court

Order extending time

Filed June 26, 1936

On this the 26 day of June, A. D. 1936, came on to be heard the motion of the defendant that the present term of the Court be continued as to this cause for a period of 75 days; and the same having been considered by the Court, it is hereby ordered and decreed that the present term of this Court be, and the same is hereby, continued and extended as to this cause for 75 days from and after this date, so that the defendant may prepare and have settled such statement of evidence, bill of exceptions, and other matters as the defendant may deem necessary and proper.

(S.) WM. H. ATWELL,
United States District Judge.

In the United States District Court

Petition for appeal

Filed Sept. 9, 1936

To the Honorable William H. Atwell, Judge of Said Court:

W. A. Thomas, Collector of Internal Revenue, defendant in the above entitled and numbered cause, feeling himself aggrieved by the judgment made and entered herein on the 11th day of June
164 1936, does hereby appeal from said judgment to the United States Circuit Court of Appeals for the Fifth Circuit for the reason set forth in the Assignment of Errors which is filed herewith.

Wherefore, premises considered, your petitioner prays that his appeal be allowed; that citation issue as provided by law; and that the transcript of the record, proceedings and papers upon which said judgment was based, which have heretofore been sent to the United States Circuit Court of Appeals for the Fifth Circuit sitting at New Orleans, in the appeal of the plaintiffs heretofore taken, be supplemented so as to include defendant's petition for appeal and assignment of errors, the court's order allowing same, and such other papers deemed necessary for defendant's appeal.

Your petitioner further prays that the proper order relating to the security for this appeal be entered.

CLYDE O. EASTUS,
United States Attorney,
FRANK B. POTTER,
Assistant United States Attorney,
J. L. BACKSTROM,
Attorney, Treasury Department,
Attorneys for Defendant.

165 In United States District Court

Order allowing appeal

Filed Sept. 9, 1936

On the 9th day of September, A. D. 1936, came on to be heard the petition of the defendant for an appeal herein, and it appearing to the Court that said petition has been presented in due season, it is hereby ordered that an appeal from the judgment entered in this cause to the United States Circuit Court of Appeals for the Fifth Circuit be, and the same is, hereby allowed, and that the certified transcript of pleadings, stipulations and proceedings herein which have heretofore been transmitted to the United States Circuit Court of Appeals for the Fifth Circuit at New Orleans in the appeal of the plaintiffs herein, be supplemented by the petition for appeal of the defendant, the assignment of errors, the order allowing same, and such other instruments and papers deemed necessary by defendant.

This appeal being prosecuted by defendant, a collector of internal revenue, on instructions of the Attorney General of the United States of America, no bond on appeal shall be required.

WM. H. ATWELL,
United States District Judge.

166 In United States District Court

Assignment of errors

Filed Sept. 9, 1936

To the Honorable William H. Atwell, Judge of Said Court:

Now comes the defendant and files this, his Assignment of Errors, as the basis for his appeal from the judgment herein rendered against him (in so far as it relates to the matter covered by the following Assignment of Errors) on the 11th day of June 1936, and says that the same is erroneous and unjust to the defendant in this:

I.

The Court erred in denying that part of the defendant's motion for judgment relating to the Ozier Ranch property, and sustaining plaintiffs' motion for judgment therefor, and finding that plaintiffs were entitled to deduction of $7,500.00 which represented three-fourths of the original purchase price of said Ozier Ranch property.

Wherefore, defendant prays that the portion of the judgment relating to the deduction allowed plaintiffs in the matter of Ozier Ranch property be reversed and that the United States Circuit Court
167 of Appeals for the Fifth Circuit grant such relief as the nature of the case demands.

CLYDE O. EASTUS,
United States Attorney,
FRANK B. POTTER,
Assistant United States Attorney,
J. L. BACKSTROM,
Attorney, Treasury Department,
Attorneys for Defendant.

In United States District Court

Waiver of issuance and service of citation on appeal

Filed Sept. 12, 1936

Now comes the plaintiffs, J. J. Perkins; and wife, Lois Perkins; by their attorneys of record, Weeks and Morrow, and Harry C. Weeks, and having been furnished copy of defendant's petition for appeal and assignment of errors herein, waive the issuance and service of citation, or further notice on appeal in this cause.

WEEKS & MORROW,
HARRY C. WEEKS,
Attorneys for Plaintiffs.

168 In United States District Court

Praecipe for record

Filed Sept. 9, 1936

To the Clerk of the District Court of the United States for the Northern District of Texas, Dallas, Texas:

SIR: You will please include in the supplemental transcript of the record for the appeal in the above entitled cause the following papers, proceedings, and documents:

1. Defendant's Application for Extension of Time and Order Thereon.
2. Petition for Appeal.
3. Order Allowing Appeal.
4. Assignment of Errors.
5. Waiver of Issuance and Service of Citation on Appeal.
6. This Praecipe and Proof of Service Thereof.

CLYDE O. EASTUS,
United States Attorney,
FRANK B. POTTER,
Assistant United States Attorney,
J. L. BACKSTROM,
Attorney, Treasury Department,
Attorneys for Defendant.

169 [Clerk's Certificate to foregoing transcript omitted in printing.]

170 That thereafter the following proceedings were had in said cause in the United States Circuit Court of Appeals for the Fifth Circuit, viz:

Argument and submission

Extract From the Minutes of November 11, 1936

No. 8172

J. J. PERKINS, ET AL.

vs.

W. A. THOMAS, COLLECTOR OF INTERNAL REVENUE

On this day this cause was called, and, after argument by Harry C. Weeks, Esq., for appellants, and Milford S. Zimmerman, Esq., Special Assistant to the Attorney General, for appellee, was submitted to the Court.

172 *Argument and submission*

Extract From the Minutes of November 11, 1936

No. 8219

W. A. THOMAS, COLLECTOR OF INTERNAL REVENUE

vs.

J. J. PERKINS, ET AL.

On this day this cause was called, and, after argument by Milford S. Zimmerman, Esq., Special Assistant to the Attorney General, for cross-appellant, and Harry C. Weeks, Esq., for cross-appellees, was submitted to the Court.

174 *Opinion of the court filed December 18, 1936*

In the United States Circuit Court of Appeals for the Fifth Circuit

Nos. 8172 and 8219

J. J. PERKINS, ET AL., APPELLANTS AND CROSS-APPELLEES

vs.

W. A. THOMAS, COLLECTOR OF INTERNAL REVENUE, APPELLEE AND CROSS-APPELLANT

Appeal and Cross-Appeal From the District Court of the United States for the Northern District of Texas

(December 18, 1936)

Before FOSTER and SIBLEY, Circuit Judges, and STRUM, District Judge

SIBLEY, Circuit Judge: Additional income taxes for the year 1933 were assessed against and paid by J. J. Perkins and his wife
175 Lois Perkins. Denied refund, they sued the Collector of Internal Revenue in the District Court, waiving jury trial. There was no conflict in the evidence. During 1931 they acquired along with others a transfer of an oil and gas lease on Texas land made in consideration of a small amount of cash and of $395,000 to be paid out of oil produced and saved. During the tax year 1933, oil having been discovered, large sums were paid to the transferors of the lease on account of this "oil payment." The Commissioner considered these sums to be income of the transferees subject to tax, though immediately paid over to the transferors, and assessed additional taxes accordingly. The district judge upheld him, preferring the reasoning in our case of Pugh vs. Commissioner, 49 Fed. (2) 76, and Comar Oil Co. vs. Blount, 64 Fed. (2) 965, from the

Eighth Circuit, to our later case of Commissioner vs. Fleming, 82 Fed. (2) 325. On another item the Perkins were shown to have purchased an interest in a tract of Texas land in 1924 for $10,000, largely because of its supposed mineral content, and had in 1928 made an oil and gas lease on it, getting a bonus therefor of about $45,000, and in the tax year 1933 they sold all their remaining interest in the minerals in the land for about $36,000. The land was completely disposed of in 1936 for about $7,000 more. In their tax return for 1928 the taxpayers claimed but were disallowed any return of capital by depletion or otherwise in taxing the bonus money. In 1933 the Commissioner again refused any deduction from the receipts from the sale of the minerals. The district judge upon uncontroverted evidence that when the land was purchased three-fourths of its value was fairly attributable to its minerals allowed deduction of $7,500 as cost of the interests sold. The Collector appeals on account of this latter ruling, and the taxpayers on account of the former.

We will examine first the cost deduction. The taxpayers
176 invested $10,000 in the purchased land including its minerals. They must be allowed a recovery of their investment, since gain only can be constitutionally taxed as income. Eisner vs. McComber, 252 U. S. 189. The statutes provide for the deduction of cost from purchase money in simple sales, and for depletion deductions where exhaustible elements of the land are drawn upon in realizing income from it otherwise than by a sale. Though in Texas an oil lease is a conveyance of an interest in land, for income tax purposes the lease is treated not as a sale but a means of getting income from the land, and not only the royalty as rent but the bonus or lump consideration also is income from the land. Burnet vs. Harmel, 287 U. S. 103. The recovery of capital to be lost in the contemplated withdrawal of the oil and paid for in advance by the bonus is taken care of by the depletion allowance to be deducted therefrom. Palmer vs. Bender, 287 U. S. 551. The taxpayers here were entitled to a depletion allowance when they made their lease for a bonus in 1928 whether they got it or not; and on a subsequent sale the statute requires that in making a deduction for cost previous deductions for depletion shall be taken into consideration. Rev. Act 1932, § 113 (b) (1). "Proper adjustment in respect of the property shall in all cases be made * * * (B) in respect of any period since Feby. 28, 1913, for exhaustion, wear and tear, obsolescence, amortization, and depletion, to the extent allowed (but not less than the amount allowable) under this Act or prior income tax laws. Where for any taxable year prior to the taxable year 1932 the depletion allowance was based on discovery value or a percentage of income, then the adjustment for depletion for such year shall be based on the depletion which would have been allowable for such year if computed without reference to discovery value or a percentage of income." The sentence last quoted applies to the bonus received in 1928 for the oil lease. At that time the depletion allowance,

177 if one had been made, would have been based on discovery value, or would have included that value in the percentage rate fixed by Congress, so that in making the adjustment on the sale in 1933 the whole allowance in 1928 would not be deducted from the cost but only a less amount reflecting a depletion based on original cost. The Collector is wrong in contending that the whole cost of the property is offset by the percentage depletion allowance that could have been made in 1928. He is wrong both because such percentage depletion is forbidden to be used in the adjustment as just pointed out, with the result that a depletion short of exhaustion can never properly exceed the whole cost; and wrong because a depletion allowance in 1928 was expressly refused. We have not a case where the taxpayer neglected to claim his deduction at the time it was due him and thus lost it. It was claimed and disallowed, and as Palmer vs. Bender, supra, had not then been decided, the ruling was acquiesced in as correct. It is manifestly unjust to allow the Government, having thus informed the taxpayer he could not have the deduction for his invested capital in 1928, now to say he could have it only then. Nor does the statute require any such attitude, for as above quoted it requires only that "proper adjustment" shall be made. Under the circumstances here disclosed nothing should be deducted from the cost basis because of this depletion allowance for 1928 which was claimed but was rejected.

The minerals were sold out in 1933 but not the surface rights. The District Judge apportioned the cost between the estate sold and that retained. This was found practicable and is fair. No regulation has been cited to us to the contrary. The minerals in the ground may be sold separately from the surface rights just as part of the acreage may be separately sold. When part of the whole is sold off an apportionment of the cost is usual if it can be made.

178 When the part retained is of little value compared to what is sold not to allow a deduction for the cost of what is sold might result in a most unfair taxation. The action of the district judge was correct.

On the question touching the oil payment we must disapprove the judgment. In dealing with income taxes in connection with transactions in oil leases this court at first attempted to apply the peculiar law of Texas or Louisiana and the resulting technical relationships of the parties. Such decisions were made in Pugh vs. Commissioner, 49 Fed: (2) 76; Harmel vs. Commissioner, 56 Fed. (2) 153; and Palmer vs. Bender, 57 Fed. (2) 33. The two last were taken to the Supreme Court and reversed, 287 U. S. 103, 287 U. S. 551, that court declaring that the income tax laws ought to have a uniform operation in all States and that income and deductions ought to result in like situations everywhere; and that a broad view ought to be taken of the transactions, deductions for depletion, for instance, being allowable to all who had an "economic interest" in the reserve in the ground regardless of the technical title to it. Adopting that

view this court in Commissioner vs. Fleming, 82 Fed. (2) 324, did not follow its decision in the Pugh case, but said: "We have thus looked at the transaction broadly as was done in Palmer vs. Bender (287 U. S. 551) and not technically as was done in the Pugh case." While the reasoning of the Pugh case may be correct upon a question of title to the oil and the ordinary consequences of title, we cannot regard it as a valid authority on the present question. Since the decision of Palmer vs. Bender other circuits have reached the conclusion we came to in the Fleming case touching the socalled "oil payments." Commissioner vs. Elliott Petroleum Co., 82 Fed. (2) 193; Alexander vs. Continental Petroleum Co., 63 Fed. (2) 927.

The instrument transferring the lease here involved uses this language: "Now, therefore, in consideration of the sum of
179 $10 * * * and the further sum of $395,000 to be paid out of the oil produced and saved from the hereinafter described lands, and to be one-fourth of all the oil produced and saved from the premises until the full sum of $395,000 is paid, we * * * do hereby bargain, sell, transfer and assign, and convey all our rights, title, and interest in and to said leases * * *. As hereinbefore stated $395,000 is to be paid to (transferors) out of the oil produced and saved from the leased premises, which payments shall be made by the pipe line Company or other purchaser of said oil and shall be one-fourth of all the oil produced and saved until the full sum of $395,000 is fully paid * * * which oil payments shall be made direct to (transferors) by the purchaser as the oil is run. The said $395,000 is payable out of oil only if, as, and when produced * * * and shall not be a personal obligation of the assignee." Whosesoever may be the technical title to the oil in the ground or that produced and saved until sold, it is plain that the transferors have an economic interest in both, and a right to specific performance of the agreement to sell and pay over a fourth of the proceeds of oil produced. According to the Fleming case they are entitled to a depletion allowance on what they get, and that means that what they receive is income and not purchase money. The share of the proceeds of the produced oil retained by the transferees is, of course, their income on which they too are entitled to an allowance for the depletion caused to them. But the portion of the proceeds going to the transferors is not the income of the transferees. It is not the proceeds of the transferees' oil paid over to the transferors in discharge of an obligation, as the district judge because of the broad words of conveyance held. Looking to the whole instrument, and noting especially that the proceeds of one-fourth of the oil saved is never to be paid by the buyer to the transferee-producer, but is to be paid direct to the transferor, and
180 that the transferee owes no money debt, but only the duty to sell the oil and submit to a division of the proceeds by the purchaser of the oil, we think it clear that for taxing purposes this share of the proceeds received by the transferor is his income alone.

The broad and general view of local transactions which has been held proper in determining whose are the depletion deductions under the federal tax statutes must for consistency's sake be applied to questions of whose is the income. The holding in this case that the proceeds of oil paid to the transferors of the lease were taxable as income to the transferee taxpayers was erroneous.

The taxpayers had an interest in another transferred lease somewhat like that above discussed, but the claim for refund made no mention of that lease or the payments to its transferors but confined itself to the lease which we have discussed. The taxpayer cannot over objection enlarge his suit beyond the scope of his claim for refund. United States vs. Felt & Tarrant Co., 283 U. S. 269; Rock Island R. R. Co. vs. U. S., 254 U. S. 141; Turner vs. Alexander, 275 U. S. 228.

Error is also assigned that full costs were not allowed to the plaintiffs because they were only partially successful. This being a suit at law the court had no discretion to divide the costs, but the plaintiffs having recovered more than $500 were entitled to full costs. In Re Peterson, 253 U. S. 300, 318; Morris vs. First National Bank, 45 Fed. (2) 577; Harlan Coal Co. vs. North American Coal Corp., 35 Fed. (2) 211; Merritt vs. Merritt, 20 Fed. (2) 541. The rule was applied in a suit against a collector of internal revenue in West End Street Ry. Co. vs. Malley, Collector, 246 Fed. 625.

The exclusion from the taxpayers' income of the "oil payments" will necessitate an adjustment of their depletion allowance
181 and possibly other things. The adjustment can be best made in the trial court. The judgment is reversed and the cause remanded for further proceedings consistent herewith.

182 *Judgment*

Extract from the Minutes of December 18, 1936

No. 8172

J. J. PERKINS, ET AL. *vs.* W. A. THOMAS, COLLECTOR OF INTERNAL REVENUE

No. 8219

W. A. THOMAS, COLLECTOR OF INTERNAL REVENUE *vs.* J. J. PERKINS, ET AL.

This cause came on to be heard on the transcripts of the record from the District Court of the United States for the Northern District of Texas, and was argued by counsel;

On consideration whereof, It is now here ordered and adjudged by this Court, that the judgment of the said District Court in this cause be, and the same is hereby, reversed; and that this cause be, and it is

hereby, remanded to the said District Court for further proceedings consistent with the opinion of this Court.

184 *Clerk's certificate*

United States of America

United States Circuit Court of Appeals for the Fifth Circuit

I, Oakley F. Dodd, Clerk of the United States Circuit Court of Appeals for the Fifth Circuit, do hereby certify that the pages numbered from 174 to 184 next preceding this certificate contain full, true, and complete copies of all the pleadings, record entries, and proceedings, including the opinion of the United States Circuit Court of Appeals for the Fifth Circuit, in certain causes in said Court, numbered 8172 and 8219 respectively, wherein J. J. Perkins, et al., are appellants, and W. A. Thomas, Collector of Internal Revenue, is appellee, and W. A. Thomas, Collector of Internal Revenue, is cross-appellant, and J. J. Perkins, et al., are cross-appellees, as full, true, and complete as the originals of the same now remain in my office.

I further certify that the pages of the printed records numbered from 1 to 173 are identical with the printed records upon which said causes were heard and decided in the said Circuit Court of Appeals.

In testimony whereof, I hereunto subscribe my name and affix the seal of the said United States Circuit Court of Appeals, at my office in the City of New Orleans, Louisiana, in the Fifth Circuit, this 10th day of March A. D. 1937.

[SEAL]

OAKLEY F. DODD,
Clerk of the United States Circuit Court of Appeals, Fifth Circuit.

185 Supreme Court of the United States

Order allowing certiorari

Filed April 5, 1937

The petition herein for a writ of certiorari to the United States Circuit Court of Appeals for the Fifth Circuit is granted.

And it is further ordered that the duly certified copy of the transcript of the proceedings below which accompanied the petition shall be treated as though filed in response to such writ.

(Endorsement on cover:) File No. 41, 364. U. S. Circuit Court of Appeals, Fifth Circuit. Term No. 824. W. A. Thomas, Collector of Internal Revenue, petitioner, vs. J. J. Perkins, et al. Petition for a writ of certiorari and exhibit thereto. Filed March 17, 1937. Term No. 824 O. T. 1936.

U. S. GOVERNMENT PRINTING OFFICE: 1937

FILED OCT 24

No. 824

In the Supreme Court of the United States

OCTOBER TERM, 1936

W. A. THOMAS, COLLECTOR OF INTERNAL REVENUE,
PETITIONER

v.

J. J. PERKINS ET AL.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FIFTH CIRCUIT

INDEX

	Page
Opinions below	1
Jurisdiction	2
Question presented	2
Statutes involved	2
Statement	2
Specification of error to be urged	5
Reasons for granting the writ	5
Conclusion	6
Appendix	7

CITATIONS

Cases:	
Comar Oil Co. v. *Burnet*, 64 F. (2d) 965, certiorari denied, 290 U. S. 652	5, 6
Palmer v. *Bender*, 287 U. S. 551	6
Pugh v. *Commissioner*, 49 F. (2d) 76, certiorari denied, 284 U. S. 642	5, 6
Standley v. *Graham Production Co.*, 83 F. (2d) 489	5
Statutes:	
Revenue Act of 1932, c. 209, 47 Stat. 169:	
Sec. 22	7
Sec. 23	7

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In the Supreme Court of the United States

OCTOBER TERM, 1936

No. —

W. A. THOMAS, COLLECTOR OF INTERNAL REVENUE,
PETITIONER

v.

J. J. PERKINS ET AL.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FIFTH CIRCUIT

The Solicitor General, on behalf of W. A. Thomas, Collector of Internal Revenue for the Second District of Texas, prays that a writ of certiorari issue to review the judgment of the United States Circuit Court of Appeals for the Fifth Circuit entered in the above-entitled cause December 18, 1936, sustaining in part and reversing in part a judgment of the United States District Court for the Northern District of Texas.

OPINIONS BELOW

The opinion of the Circuit Court of Appeals [1] is reported at 86 F. (2d) 954. The opinion of the

[1] There were two transcripts of record before the Circuit Court of Appeals, one in No. 8172 and one in No. 8219. Record references are to the record in No. 8172.

District Court (R. 23–30) is reported at 15 F. Supp. 356.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered December 18, 1936. The jurisdiction of this Court is invoked under Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTION PRESENTED

By virtue of a contract of assignment, the taxpayers owned an undivided fractional interest in an oil and gas lease, and in addition to a cash payment made at the time of the assignment, were obligated to pay to the assignors a further sum as oil payments if and when a certain amount of oil were produced from the property. Should the taxpayers' gross income include that part of the proceeds from the sale of the oil which was paid to the assignors of the lease as oil payments under the contract?

STATUTES INVOLVED

The statutes involved will be found in the Appendix, *infra*, p. 7.

STATEMENT

The petition of the taxpayers, who are husband and wife, filed in the District Court, seeks to recover a portion of the income tax paid by them for the year 1933 upon their community income. (R. 6–14.)

J. J. Perkins, in association with W. J. Green and Faith Oil Corporation, was interested in certain oil and gas properties located in East Texas. (R. 32.) The interest of Perkins in the property here concerned was at all times involved herein an undivided three-eighths part of the joint interest. (R. 32–33.)

Among the properties operated by these parties was a property covered by a lease which may, for convenience, be called the Hammonds and Branson lease. (R. 33.) On July 24, 1931, the Hammonds and Branson lease was assigned to Faith Oil Corporation, which acted for itself, Perkins, and Green. The pertinent portions of this contract of assignment are set out in the record (pp. 33–36). The contract recited a consideration of $10 cash paid and the further sum of $395,000 to be paid out of one-fourth of the oil produced until that amount was paid in full to the assignors by the purchasers of the oil. This oil payment was to be made only if, as and when sufficient oil was produced, and it was stated that the payment should not constitute a personal obligation of the assignees.

At the time of these contracts, there were no producing wells upon the property in question. (R. 33.) From the considerable subsequent oil production on the Branson and Hammonds property, about one-half of the oil payment of $395,000 has already been paid. The balance will be paid within two and one-half years. (R. 77.)

As the oil was produced from the property here concerned, it was run into tanks, and division orders were executed to the pipe line companies, providing that the payment of the purchase price for the oil should be made directly to the operators, the assignors, and the lessors, respectively, in accordance with their contractual rights. (R. 50.)

In their income tax returns for 1933, the taxpayers did not include the oil payments made to Branson and Hammonds. The Commissioner of Internal Revenue assessed deficiencies based upon the inclusion of the oil payments in the taxpayers' gross income. (R. 77.) The taxpayers were allowed depletion on this addition to their gross income. (R. 138–139.) After payment of the assessments, the taxpayers filed claims for refund of the tax computed upon the inclusion of the oil payments to Branson and Hammonds within the gross income of the taxpayers. The claims for refund were rejected by the Commissioner. (R. 14.)

The taxpayers have admitted that if it is held that the oil payments should not be included in their gross income, the depletion deduction allowed to them must be reduced.

The District Court held that the amount of these oil payments under the Hammonds and Branson assignment should be included within the gross income of the taxpayers. (R. 24–30.) The Circuit Court of Appeals in reversing the judgment held

that the amount of the oil payments should be excluded from the taxpayers' income.

SPECIFICATION OF ERROR TO BE URGED

The Circuit Court of Appeals erred in holding that the amount of the oil payments made by the taxpayers to the assignors of the Branson and Hammonds lease should be excluded from the gross income of the taxpayers.

REASONS FOR GRANTING THE WRIT

1. The decision of the Circuit Court of Appeals in this case is squarely in conflict with the decision of the Circuit Court of Appeals for the Eighth Circuit in *Comar Oil Co.* v. *Burnet*, 64 F. (2d) 965, certiorari denied, 290 U. S. 652. The contracts of assignment in that case were substantially identical with the instant contract. The court there held that the title to all of the oil in place passed under the assignments, and that the amount of the oil payments was to be included within the gross income of the assignees. The payments were to be treated as capital expenditures, not deductible from gross income.

The District Court relied upon *Comar Oil Co.* v. *Burnet, supra*, and also cited *Pugh* v. *Commissioner*, 49 F. (2d) 76 (C. C. A. 5th), certiorari denied, 284 U. S. 642, and *Standley* v. *Graham Production Co.*, 83 F. (2d) 489 (C. C. A. 5th). In its opinion, the Circuit Court of Appeals expressly

declined to follow the *Comar* case. Likewise, its own reasoning in the *Pugh* case was rejected on the asserted authority of *Palmer* v. *Bender*, 287 U. S. 551. While the *Pugh* case may have been overruled in principle by *Palmer* v. *Bender*, *supra*, in so far as the question of depletion was involved, we submit that it still declares valid law as to the questions of title and the construction of the contracts.

2. This question as to the oil payments is highly important because it is a common practice in oil and gas contracts to provide for payment in that manner. A large number of cases involving this question are now pending before the District Courts and the Board of Tax Appeals. The District Court in its opinion visualized the economic effect of a decision adverse to the Government.

CONCLUSION

It is respectfully submitted that a writ of certiorari should be granted because of the clear conflict between decisions of two Circuit Courts of Appeals and because of the manifest importance of the question presented.

STANLEY REED,
Solicitor General.

MARCH 1937.

APPENDIX

Revenue Act of 1932, c. 209, 47 Stat. 169:

SEC. 22. GROSS INCOME.

(a) *General Definition.*—"Gross income" includes gains, profits, and income derived from salaries, wages, or compensation for personal service, or whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. * * *

SEC. 23. DEDUCTIONS FROM GROSS INCOME.

In computing net income there shall be allowed as deductions:

* * * * * *

(l) DEPLETION.—In the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case; such reasonable allowance in all cases to be made under rules and regulations to be prescribed by the Commissioner, with the approval of the Secretary. * * * In the case of leases the deductions shall be equitably apportioned between the lessor and lessee. * * *

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No. 824

In the Supreme Court of the United States

OCTOBER TERM, 1936

W. A. THOMAS, COLLECTOR OF INTERNAL REVENUE,
PETITIONER

v.

J. J. PERKINS ET AL.

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FIFTH CIRCUIT

BRIEF FOR THE PETITIONER

INDEX

	Page
Opinions below	1
Jurisdiction	1
Question presented	2
Statutes involved	2
Statement	2
Specification of error to be urged	4
Summary of argument	5
Argument:	
I. The taxpayers' gross income includes all of the proceeds from the sale of the oil produced	6
II. The taxpayers are not entitled to a deduction on account of the payments to the assignors of the leases	17
Conclusion	20
Appendix	21

CITATIONS

Cases:	
Alexander, Collector v. Continental Petroleum Co., 63 F. (2d) 927	7
Baton Coal Co. v. *Commissioner*, 51 F. (2d) 469	20
Bull v. *United States*, 295 U. S. 247	15
Burnet v. *Leininger*, 285 U. S. 136	16
Comar Oil Co. v. *Burnet*, 64 F. (2d) 965, certiorari denied, 290 U. S. 652	16, 18
Commissioner v. *Elliott Petroleum Corp.*, 82 F. (2d) 193	7
Commissioner v. *Fleming*, 82 F. (2d) 324	7
Consolidated Royalty Oil Co. v. *Commissioner*, 31 B. T. A. 107	18
Douglas v *Willcuts*, 296 U. S. 1	16
Duffy v. *Centrql R. R.*, 268 U. S. 55	19
Eldredge v. *United States*, 31 F. (2d) 924	17
Group No. 1 Oil Corp. v. *Bass*, 283 U. S. 279	13
Herold v. *Commissioner*, 42 F. (2d) 942	17
Hill v. *Commissioner*, 38 F. (2d) 165, certiorari denied, 281 U. S. 761	15
Holliday v. *Erwin*, 85 S. W. (2d) 355	11, 13, 18
Jefferson Gas Coal Co. v. *Commissioner*, 52 F. (2d) 120	17
Lynch v. *Alworth-Stephens Co.*, 267 U. S. 364	19
Miller v. *Hodges*, 260 S. W. 168	13
S. Naitove & Co., Inc. v. *Commissioner*, 32 F. (2d) 949, certiorari denied, 280 U. S. 582	15

140278—37——1

Cases—Continued. Page

Old Colony Trust Co. v. *Commissioner*, 279 U. S. 716 16
Palmer v. *Bender*, 287 U. S. 551 7
Poe v. *Seaborn*, 282 U. S. 101 8
Pope v. *Commissioner*, 39 F. (2d) 420 15
Pugh v. *Commissioner*, 49 F. (2d) 76, certiorari denied, 284 U. S. 642 17
Rogers v. *Hill*, 289 U. S. 582 15
Rensselaer & S. R. Co. v. *Irwin*, 249 Fed. 726 16
Sheffield v. *Hogg*, 124 Tex. 290, 77 S. W. (2d) 1021 13
Simms Oil Co. v. *Colquitt*, 2 S. W. (2d) 421 13
Stratton's Independence v. *Howbert*, 231 U. S. 399 9
Theisen v. *Robison*, 117 Tex. 489 13
Waller v. *Commissioner*, 40 F. (2d) 892 17
West End St. Ry. Co. v. *Malley*, 246 Fed. 625 16

Statute:

Revenue Act of 1932, c. 209, 47 Stat. 169:
Sec. 11 21
Sec. 12 21
Sec. 22 21
Sec. 23 21

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BRIEF FOR THE PETITIONER

OPINIONS BELOW

The opinion of the Circuit Court of Appeals (R. 96) is reported at 86 F. (2d) 954. The opinion of the District Court (R. 15) is reported at 15 F. Supp. 356.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered December 18, 1936. (R. 100.) Petition for writ of certiorari was filed on March 17, 1937, and granted on April 5, 1937. The jurisdic-

tion of this Court is invoked under Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTION PRESENTED

By virtue of a contract of assignment, the taxpayers owned an undivided fractional interest in an oil and gas lease, and, in addition to a cash payment made at the time of the assignment, were obligated to pay to the assignors a further sum as oil payments if and when a certain amount of oil was produced from the property. Should the taxpayers' gross income include that part of the proceeds from the sale of the oil which was paid to the assignors of the lease as oil payments under the contract?

STATUTES INVOLVED

The statutes involved will be found in the Appendix, *infra*, pp. 21–22.

STATEMENT

The petition of the taxpayers, who are husband and wife, filed in the District Court, seeks to recover a portion of the income tax paid by them for the year 1933 upon their community income. (R. 4–9.)

J. J. Perkins, the taxpayer, in association with W. J. Green and the Faith Oil Corporation, was interested in certain oil and gas properties located in East Texas. (R. 21.) The interest of Perkins in the property here concerned was at all time in-

volved herein an undivided three-eighths part of the joint interest. (R. 21.)

Among the properties operated by these parties was a property covered by a lease which may, for convenience, be called the Hammonds and Branson lease. (R. 21.) On July 24, 1931, the Hammonds and Branson lease was assigned to Faith Oil Corporation, which acted for itself, Perkins, and Green. (R. 21–23, 27–29.) The pertinent portions of this contract of assignment are set out in the record (pp. 21–23). The contract recited a consideration of $10 cash paid and the further sum of $395,000 to be paid out of one-fourth of the oil produced until that amount was paid in full to the assignors by the purchasers of the oil. The actual consideration for the contract, however, was $105,000 in cash, notes for $50,000, which were later paid, and the contingent oil payments. (R. 27.) This oil payment was to be made only if, as and when sufficient oil was produced, and it was stated that the payment should not constitute a personal obligation of the assignees. (R. 22.)

At the time of this contract, there were no producing wells upon the property in question. (R. 21.)

As the oil was produced from the property here concerned, it was run into tanks, and division orders were executed to the pipe line companies, providing that the payment of the purchase price for the oil should be made directly to the operators,

the assignors, and the lessors, respectively, in accordance with their contractual rights. (R. 32.)

In their income tax returns for 1933, the taxpayers did not include the proceeds of sales of oil which were paid to Branson and Hammonds. The Commissioner of Internal Revenue assessed deficiencies based upon the inclusion of the amounts of these oil payments in the taxpayers' gross income. (R. 48.) The taxpayers were allowed depletion on this addition to their gross income. (R. 83.) After payment of the assessments, the taxpayers filed claims for refund of the tax computed upon the inclusion within their gross income of the oil payments to Branson and Hammonds. The claims for refund were rejected by the Commissioner. (R. 12.)

The taxpayers have admitted that if it is held that the oil payments should not be included in their gross income, the depletion deduction allowed to them must be reduced. (R. 83.)

The District Court held that the amount of these oil payments under the Hammonds and Branson assignment should be included within the gross income of the taxpayers. (R. 15–19.) The Circuit Court of Appeals in reversing the judgment held that the amount of the oil payments should be excluded from the taxpayers' income. (R.100.)

SPECIFICATION OF ERROR TO BE URGED

The Circuit Court of Appeals erred in holding that the amount of the oil payments made by the

taxpayers to Branson and Hammonds, the assignors, should be excluded from the gross income of the taxpayers.

SUMMARY OF ARGUMENT

The taxpayers and associates operated oil wells and sold the oil. The proceeds of all of the sales of oil made by them constituted income from their business and should be included in their gross income. Furthermore, they had by a contract of assignment acquired complete title to the oil leases under which they operated and also to all of the oil in place. By the provision in the contract of assignment of the leases for the payment of part of the consideration in the amount of $395,000 out of oil produced the assignors of the leases neither retained an interest in the leases nor in the oil in place. Since the capital and labor entering into the production of the income here in question was owned and furnished entirely by the taxpayers and their associates the entire proceeds of sales of oil made by them are to be included in their gross income. The payments made to the assignors of the leases out of oil produced constituted part of the purchase price of the leases and were a capital expenditure. The payments may not be deducted as an expense. The taxpayers recover back their capital outlay through an allowance for depletion.

ARGUMENT

THE TAXPAYERS' GROSS INCOME INCLUDES ALL OF THE PROCEEDS FROM THE SALE OF THE OIL PRODUCED

During the year 1933 the taxpayers, in association with another individual and a corporation, extracted oil and gas from certain wells in Texas under leases which had theretofore been assigned to them. As consideration for the assignment of the leases, the taxpayers and their associates had paid to the assignors $105,000 in cash and $50,000 in notes, and had agreed to pay the further sum of $395,000 out of one-fourth of the first oil produced. It was provided that the agreement to make the payment of $395,000 out of oil produced was not to impose a personal obligation upon the assignees of the leases. The question is whether the proceeds of sales of oil paid over to the assignors of the leases constituted income of the taxpayers and their associates.

It was argued below on behalf of the taxpayers that the assignment of the leases was not intended to convey and did not convey all of the assignors' interest in the oil in place or their "property right" or "economic interest" therein, but that there was a clear intention to retain title to a certain amount of oil, and that accordingly the assignors' situation was that of a part owner, and not that of a creditor. The court below, in reversing the decision of the District Court, deemed the question of title to the oil in the ground or that produced and saved until sold

unimportant, holding that the question of whose is the income from the production of oil should be approached from the broad and general view of local transactions which has been held proper in determining whose are the depletion deductions under the Federal tax statutes (citing *Palmer* v. *Bender*, 287 U. S. 551), and that from this approach it was plain that the assignors had an economic interest in the oil in place and that produced and sold; hence that the proceeds of the sales of oil which were paid over to the assignors were not income of the taxpayers.

At the outset, we do not admit that when an oil lease has been completely transferred by assignment for a stated sum of money, the assignors of the lease have such an economic interest in the oil in place as to entitle them to depletion, even though payment of a part of the agreed sum may be contingent upon the production of a certain quantity of oil. Several of the lower courts, purporting to follow this Court's decision in *Palmer* v. *Bender*, *supra*, have so held,[1] but we believe that those decisions constitute an unwarranted extension of the depletion statutes. However, the question of depletion is not now before the Court. It is clear that a decision of that question turns on the language of the depletion provisions of the statute and

[1] See *Commissioner* v. *Fleming*, 82 F. (2d) 324 (C. C. A. 5th); *Commissioner* v. *Elliott Petroleum Corporation*, 82 F. (2d) 193 (C. C. A. 9th); *Alexander, Collector* v. *Continental Petroleum Co.*, 63 F. (2d) 927 (C. C. A. 10th).

the peculiar benefits granted by those provisions. The sections of the statute to which we look to determine what is taxable income and to whom it shall be taxed are different from the depletion provisions, and an examination of them will disclose no basis for holding that an "economic interest" in the profits from another's capital or labor will exempt those profits from taxation to that person whose capital or labor produced the profits.

Section 11 of the Revenue Act of 1932 lays a normal tax upon the "net income of every individual", Section 12 provides for a surtax. In Section 22 "gross income" is defined as including "gains, profits, and income derived from * * * trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from * * * the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever."

In *Poe* v. *Seaborn,* 282 U. S. 101, 109–110, this Court considered similar provisions of the Revenue Act of 1926, and held that the test laid down by Congress for the income tax upon an individual is one of ownership, and that the answer to the question of ownership must be found in the provisions of the law of the State.

The most quoted definition of income is that it is the product of capital or labor, or both combined.

Accordingly, if we find that under state law a particular taxpayer owns the capital which enters into the production of particular income and also performs the labor entailed in its production, it follows that that taxpayer is taxable under the Federal revenue laws upon that income.

This Court in *Stratton's Independence* v. *Howbert,* 231 U. S. 399, 415, described the process of mining in the following language:

> But when a company is digging pits, sinking shafts, tunneling, drifting, stoping, drilling, blasting, and hoisting ores, it is employing capital and labor in transmuting a part of the realty into personalty, and putting it into marketable form. The very process of mining is, in a sense, equivalent in its results to a manufacuring process. And, however the operation shall be described, the transaction is indubitably "business" within the fair meaning of the act of 1909; and the gains derived from it are properly and strictly the income from that business; for "income" may be defined as the gain derived from capital, from labor, or from both combined, and here we have combined operations of capital and labor.

If, as held in the *Stratton's Independence* case *supra,* profits from the sales of mineral products are income from a business analogous to a manufacturing process, it would seem to follow that those who own and conduct that business are the ones to be taxed on its profits. It, of course, has not

been and cannot be argued that the persons who assigned the oil leases to the taxpayers and their associates were partners or co-adventurers in the conduct of the business of extracting the oil from the ground and putting it upon the market. The argument of the taxpayers is that the assignors formerly owned, and still retained an interest in, some of the property used in the business, that is, an interest in the oil in place and the oil produced and saved. We think, however, it is perfectly clear that the use by one in his business of property owned by another would not prevent the gain or profit arising out of the use of that property from being considered the income of the one conducting the business. If he has paid for the use of the property, then he must look to other provisions of the revenue laws to ascertain if he is entitled to a deduction for such payments.

Furthermore, the argument of the taxpayers that the assignors retained an interest in the oil in place and in the oil produced and saved is contrary to the plain terms of the contract of assignment and to the law of Texas. The assignment provided (R. 21–22):

> * * * in consideration of the sum of Ten Dollars ($10.00), cash in hand [actually, this part of the consideration was $105,000.00 in cash and $50,000.00 in notes (R. 27)], paid by Faith Oil Corporation, a Texas Corporation, and of the further sum of Three Hundred Ninety Five Thousand Dol-

> lars ($395,000.00) to be paid out of the oil produced and saved from the hereinafter described lands, and to be one-fourth of all the oil produced and saved from the premises hereinafter described, until the full sum of Three Hundred and Ninety Five Thousand Dollars ($395,000.00) is paid, we, * * *, the present owners of said leases hereinafter described and all rights thereunder and incident thereto, *do hereby bargain, sell, transfer, assign, and convey all our rights, title, and interest in and to said leases and rights thereunder,* hereinafter described, * * * to Faith Oil Corporation, its successors and assigns * * * [Faith Oil Corporation's interest in this assignment is ¼ and the taxpayers ⅜; R. 27–29, 21]. [Italics added.]

We should think that the italicized language above would be considered so clear as to admit of no doubt that the assignors assigned all of their interest in the leases and rights thereunder. An argument similar to that made by the taxpayers, however, was made before the Court of Civil Appeals of Texas in *Holliday* v. *Erwin,* 85 S. W. (2d) 355. The assignment involved in that case provided:

> Now, therefore, for and in consideration of the sum of Five hundred and no/100 dollars ($500.00) cash in hand paid, the receipt of which is hereby acknowledged, and the further sum of sixteen thousand two hundred fifty and no/100 dollars ($16,250.00)

> payable out of one-fourth (¼th) of seven-eighths (⅞th) of the first oil only as, if and when produced, saved and sold from the above described land, which sum is exclusive and in addition to the sum of seventy-five and No/100 dollars ($75.00) per acre payable to the original lessor under the terms of the original lease, the undersigned, the present owner of said lease and all rights thereunder or incident thereto, does hereby bargain, sell, transfer, assign and convey all rights, title and interest of the original lessee and present owner in and to said lease and rights thereunder, insofar as it covers the above described land, together with all personal property used or obtained in connection therewith to Walter D. Caldwell and his heirs, successors and assigns.

The plaintiff in that case, Erwin, was the assignor of the leases, and he sought, among other things, a decree declaring him to be the owner of one-fourth of seven-eighths of the first oil produced until the full sum of $16,250 had been paid to him. In rejecting his contention, the court said (p. 356):

> It is clear to our minds that in this assignment Erwin conveyed all rights, title, and interest which he held in said 50 acres of land for the consideration of $500 in cash and the further conditional promise to pay him the sum of $16,250, payable out of one-fourth of seven-eighths of the first oil, only, as, if, and when produced, saved, and sold from said 50 acres of land. The assignment

> does not contain a provision that Erwin is entitled to receive one-fourth of seven-eighths of the first oil produced, nor does it contain a provision that the title to such oil shall remain in Erwin until he is paid. He simply conveys all his rights in the lease for so much cash and a conditional promise to pay $16,250.

The taxpayers in the present case relied below principally upon *Sheffield* v. *Hogg*, 124 Tex. 290, 77 S. W. (2d) 1021. In *Holliday* v. *Erwin, supra*, a motion for rehearing was made upon the ground that the decision there was in conflict with *Sheffield* v. *Hogg, supra*. The court, in overruling the motion for rehearing, pointed out the differences between the two cases and stated that the assignor, Erwin, in the case before it, "was not to receive anything as rents or royalty; he was to receive purchase money." Cf. *Simms Oil Co.* v. *Colquitt*, 2 S. W. (2d) 421 (Tex.); and *Miller* v. *Hodges*, 260 S. W. 168 (Tex.). In this latter case, the court held that an assignment of all the "right, title, and interest in and to the leases aforesaid, and all rights thereunder" operated to convey the leases and as well to convey the same title to the minerals that the leases themselves conveyed. See also *Group No. 1 Oil Corp.* v. *Bass*, 283 U. S. 279, 281, where this Court quoted with approval from *Theisen* v. *Robison*, 117 Tex. 489, 510–511, as follows:

> They [the leases] do not authorize the purchaser to take and use seven-eighths or

> any other mere fractional part of the oil or gas in the land leased. The purchaser instead buys *all* the oil and gas, for a stipulated price, part of the price being measured by the value of a certain fraction of the *produced* oil and gas, which is a very different thing from the value of that fraction of the oil and gas in place. The leases convey all the oil and gas in granting the right to find, produce, and appropriate *all* of them, in consideration of the payment of stipulated sums and also the value of a stated fraction of the oil and gas produced.

It thus appears, we submit, that the taxpayers (and their associates) acquired the complete title to and interest in the leases under which the oil, the proceeds of which are in question here, was produced; they had under the law of Texas ownership of the oil in place; they alone had the right to extract the oil and sell it; and the business of extracting and selling the oil was operated solely by them for their own benefit. The profits of the business are therefore taxable to them. The fact that the assignors of the leases were to receive as part of the selling price of the leases a stated sum out of the proceeds of sale of certain of the oil does not make them partners in the business, nor prevent the income from the business from being taxed to its owners. The problem thus presented is not one peculiar to the oil industry, and it is not material to the solution of the problem that the payments to the assignors of the leases may be

called "oil payments", or that the payments are made directly to the assignors by the pipe line company. It is the same problem which is presented when any property or business is transferred and the purchase price is to be paid in part from the operations of the business.

Partnership contracts, for example, often provide that the estate of a deceased partner shall allow his interest to remain in the business in return for a share of the partnership earnings over a period of time. The courts have stated that such a transaction is a sale, and that the entire earnings are taxable to the surviving partners, with no expense deduction allowed to them for the payments to the estate of the deceased partner. *Hill* v. *Commissioner,* 38 F. (2d) 165 (C. C. A. 1st), certiorari denied, 281 U. S. 761; *Pope* v. *Commissioner,* 39 F. (2d) 420 (C. C. A. 1st). Cf. *Bull* v. *United States,* 295 U. S. 247, 254.

Corporations not infrequently enter into contracts with their officers and employees to pay them as compensation a certain percentage of the net profits of the business of the corporation. See *S. Naitove & Co. Inc.* v. *Commissioner,* 32 F. (2d) 949 (App. D. C.), certiorari denied, 280 U. S. 582; *Rogers* v. *Hill,* 289 U. S. 582. The fact that the employees share in the net profits does not provide a ground for the exclusion of those profits from the gross income of the corporation. Whether the corporation may be permitted an offsetting deduction depends upon other considerations.

That profits earned by a taxpayer are taxable to him without regard to whether they are directly received by him is, we submit, well settled. Cf. *Old Colony Trust Co.* v. *Commissioner,* 279 U. S. 716, where an employee was required to include in his income money which his employer paid directly over to the United States to satisfy a tax upon the employee; *Douglas* v. *Willcuts,* 296 U. S. 1, where a husband was taxed with the income from a trust created by him providing for annual payments to his divorced wife in lieu of alimony; *Burnet* v. *Leininger,* 285 U. S. 136, 141, where a husband was taxed with the entire income from his interest in a partnership, notwithstanding the prior assignment of one-half of the "corpus" of his interest to his wife; and *West End St. Ry. Co.* v. *Malley,* 246 Fed. 625 (C. C. A. 1st), and *Rensselaer & S. R. Co.* v. *Irwin,* 249 Fed. 726 (C. C. A. 2d), where a corporation leasing property was taxed with amounts paid directly to its stockholders by the lessee.

In *Comar Oil Co.* v. *Burnet,* 64 F. (2d) 965 (C. C. A. 8th), certiorari denied, 290 U. S. 652, contracts essentially similar to that in the instant case were involved, and the same question here presented was raised. The court in that case held that the assignor of the leases had completely conveyed whatever title he had and that the oil payments to the assignor, called "overriding royalties", were not to be excluded from the income of

the assignee, nor were deductions allowed for the payments.

This conclusion accords in principle with the earlier decisions of the court below in *Pugh* v. *Commissioner*, 49 F. (2d) 76, certiorari denied, 284 U. S. 642; *Herold* v. *Commissioner*, 42 F. (2d) 942; *Waller* v. *Commissioner*, 40 F. (2d) 892; and the decisions of the Third and Sixth Circuits in *Jefferson Gas Coal Co.* v. *Commissioner*, 52 F. (2d) 120 (C. C. A. 3d) and *Eldredge* v. *United States*, 31 F. (2d) 924 (C. C. A. 6th).

From the foregoing, we submit that the court below was in error in holding that the proceeds of sales of oil paid over to the assignors of the leases were not income of the taxpayers.

II

THE TAXPAYERS ARE NOT ENTITLED TO A DEDUCTION ON ACCOUNT OF THE PAYMENTS TO THE ASSIGNORS OF THE LEASES

In the court below the taxpayers devoted their argument principally to the contention that the proceeds of oil paid over to the assignors of the leases were not income to the assignees, the taxpayers, and the court below agreed with their contention. If this Court, however, should not uphold the lower court's decision, the taxpayers will doubtless contend that they are entitled to a deduction from gross income on account of the payments made to their assignors.

To be entitled to a deduction a taxpayer must show that such deduction is clearly authorized by statute. Our contention is that the payments made to the assignors were part of the purchase price of the leases, and as such represented a capital expenditure to be recovered in the allowance made by the statute for depletion. There can be no duplicate allowance for those disbursements as a separate deduction. Admittedly, in this case the taxpayers have received the benefit of a depletion allowance not only on the proceeds of sales of oil which they retained but also on the proceeds of sales of oil which were paid over to the assignors. There is no provision of statute to which they can point authorizing any other deduction. The only possible contention that could be made is that these payments to the assignors were in the nature of "rentals or other payments required to be made as a condition to the continued use or possession, for purposes of the trade or business, of property to which the taxpayer has not taken or is not taking title or in which he has no equity." Section 23, Revenue Act of 1932, *infra,* pp. 21–22. The taxpayers stated in their brief below, however, that these payments did not purport to be rents or royalties, and clearly they were not. They were part of the purchase price of the leases, a capital asset. *Consolidated Royalty Oil Co.* v. *Commissioner,* 31 B. T. A. 107; *Comar Oil Co.* v. *Burnet, supra.* The Court of Civil Appeals of Texas in *Holliday* v.

Erwin, supra, settled that question where an assignment in all material respects like the assignment in the present case was involved. As stated above, the court there held that "Defendant in error [the assignor] was not to receive anything as rents or royalty; he was to receive purchase money."

This Court in *Duffy* v. *Central R. R.*, 268 U. S. 55, had before it the statutory provision for deduction of rentals and "other payments", and there concluded, pages 63–64, that "The term 'rentals,' since there is nothing to indicate the contrary, must be taken in its usual and ordinary sense, that is, as implying a fixed sum, or property amounting to a fixed sum, to be paid at stated times for the use of property," and that the phrase "or other payments" was "meant to bring in payments *ejusdem generis* with 'rentals,' such as taxes, insurance, interest on mortgages, and the like, constituting liabilities of the lessor on account of the leased premises which the lessee has covenanted to pay." In that case this Court held that expenditures which a lessee was required to make for betterments and additions to leased premises could not be deducted under the term "rentals", but that the lessee might obtain a return of its expenditures by an annual depreciation.

In the present case the capital expenditure to purchase the leases is recovered back through the allowance for depletion. *Lynch* v. *Alworth-Ste-*

phens Co., 267 U. S. 364, 370. Cf. *Baton Coal Co.* v. *Commissioner*, 51 F. (2d) 469 (C. C. A. 3d).

We submit, therefore, that under the terms of the contract of assignment the title to the leases, title to all of the oil and gas in place, and the exclusive right to extract and sell that oil and gas passed to the taxpayers and their associates. The income from the operation of the wells and sales of the oil was chargeable in its entirety to them. The oil payments merely represented a portion of the purchase price of the leases and were not deductible, since they were capital expenditures.

CONCLUSION

For the foregoing reasons it is respectfully submitted that the decision of the court below should be reversed.

Respectfully submitted.

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APRIL 1937.

APPENDIX

Revenue Act of 1932, c. 209, 47 Stat. 169:

SEC. 11. NORMAL TAX ON INDIVIDUALS.

There shall be levied, collected, and paid for each taxable year upon the net income of every individual a normal tax equal to the sum of the following:

* * * * *

SEC. 12. SURTAX ON INDIVIDUALS.

(a) *Rates of Surtax.*—There shall be levied, collected, and paid for each taxable year upon the net income of every individual a surtax as follows:

* * * * *

SEC. 22. GROSS INCOME.

(a) *General Definition.*—"Gross income" includes gains, profits, and income derived from salaries, wages, or compensation for personal service, of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. * * *

SEC. 23. DEDUCTIONS FROM GROSS INCOME.

In computing net income there shall be allowed as deductions:

(a) *Expenses.*—All the ordinary and necessary expenses paid or incurred during the

taxable year in carrying on any trade or business, including a reasonable allowance for salaries or other compensation for personal services actually rendered; traveling expenses (including the entire amount expended for meals and lodging) while away from home in the pursuit of a trade or business; and rentals or other payments required to be made as a condition to the continued use or possession, for purposes of the trade or business, of property to which the taxpayer has not taken or is not taking title or in which he has no equity.

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No. 824

In the Supreme Court of the United States

OCTOBER TERM, 1936

W. A. THOMAS, COLLECTOR OF INTERNAL REVENUE,
PETITIONER

v.

J. J. PERKINS ET AL.

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FIFTH CIRCUIT

REPLY BRIEF FOR THE PETITIONER

INDEX

CITATIONS

Cases:	Page
Barwise v. *Sheppard*, 299 U. S. 33	4
Blair v. *Commissioner*, No. 247, October Term, 1936	3
Burnet v. *Coronado Oil & Gas Co.*, 285 U. S. 393	6
Comar Oil Co. v. *Burnet*, 64 F. (2d) 965, certiorari denied, 290 U. S. 652	1, 8
Commissioner v. *Fleming*, 82 F. (2d) 324	14
Doyle v. *Mitchell Brothers Co.*, 247 U. S. 179	13
Dunn v. *Tennant*, 82 S. W. 728	5
Edwards Drilling Co. v. *Commissioner*, 35 B. T. A. 341	14
Gillespie v. *Oklahoma*, 257 U. S. 501	6
Group No. 1 Oil Corp. v. *Sheppard*, 89 S. W. 1021	3
Helvering v. *Twin Bell Syndicate*, 293 U. S. 312	8
Lynch v. *Hornby*, 247 U. S. 339	10
Palmer v. *Bender*, 287 U. S. 551	7, 8
Poe v. *Seaborn*, 282 U. S. 101	7
Sheffield v. *Hogg*, 124 Tex. 290	3
Shell Petroleum Corp. v. *State*, 86 S. W. 245	3
Theisen v. *Robison*, 117 Tex. 489	3, 8
United States v. *Phellis*, 257 U. S. 156	9
Waggoner Estate v. *Wichita County*, 273 U. S. 113	3
Statute:	
Revenue Act of 1932, c. 209, 47 Stat. 169:	
Sec. 23	16
Sec. 102	17
Sec. 114	17

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Certiorari was applied for and presumably granted solely to resolve a conflict with *Comar Oil Co.* v. *Burnet*, 64 F. (2d) 965 (C. C. A. 8th), certiorari denied, 290 U. S. 652, with respect to the question whether all of the proceeds from the sale of oil, including the portion paid to the prior owners of the leases, should be included in the operators' gross income. Our main brief is devoted to a discussion of that question. We contend that since the taxpayers were the operators as well as the owners of the oil leases which produced the income, they were chargeable with all of the income

produced by the business which they conducted. In addition, we contend that the payments which the taxpayers made to their assignors in consideration of the assignment of the leases were made for the transfer of property to which the taxpayers were taking title, and hence were not deductible as business expenses under the plain terms of the statute.[1].

Respondents do not deny that the amount sought to be taxed is income. Their position is that it is not their income but that of the assignors. Such a question depends upon the ownership of the property which produced the income, and it must be determined by resort to local law. In our main brief we have shown that under local law the taxpayers and not the assignors were the owners of the leases and of the oil in place. The terms of the assignment by which respondents acquired the leases are consistent with no other construction. The assignment recited that the assignors "do hereby bargain, sell, transfer, assign and convey all our rights, title, and interest in and to said leases and rights thereunder * * *." (R. 22.) Respondents, however, contend that they never acquired an interest in so much of the oil as will be necessary to satisfy the oil payments. We think that the Texas decisions cited fall far short of sustaining that contention.

---

[1] Respondents were permitted to capitalize the oil payments as made. (R. 67.)

Sheffield v. *Hogg,* 124 Tex. 290, 77 S. W. (2d) 1021, upon which respondents chiefly rely, does not decide that the holder of a royalty interest is the owner of oil in place or part owner of the lease. It decides (p. 298) that the royalty holders have a fee simple interest in land, "or at least have a right belonging or appertaining to the horizontal strata of the land in which the minerals are embedded." The question there involved concerned a real estate tax, and while it may be sufficient for purposes of classification that the royalty owner has a right belonging or appertaining to the land, we submit that decision does not deny that the operating lessee owns the oil and the lease. The Texas courts still cite *Theisen* v. *Robison,* 117 Tex. 489, as authority for the proposition that a lessee acquires title to all of the oil and gas in place. *Group No. 1 Oil Corp.* v. *Sheppard,* 89 S. W. 1021, 1024. See, also, *Waggoner Estate* v. *Wichita County,* 273 U. S. 113; and *Shell Petroleum Corp.* v. *State,* 86 S. W. (2d) 245, 249. For purposes of an income tax there is no escape from the proposition that the income belongs to the owner of the business and the argument that, because of the lessor's interest, the proceeds from the sale of oil belong to him directly is quite inadmissible.

The situation in this case is a typical example of income assigned to pay an obligation. Cf. *Blair* v. *Commissioner,* No. 247, decided by this Court February 1, 1937. Respondents have assigned their in-

come to pay for the lease. Respondents constructively receive the income from extraction and sale of the oil and respondents' assignors receive purchase money which may or may not represent income. Respondents do not have a deduction for rent, because they have bought the lease.

The contention that respondents had no obligation because the assignment provided (R. 22) that the oil payment did not constitute a personal obligation is unsound. Because the assignors were willing to look exclusively to the oil payments for their money does not alter the fact that respondents' original obligation to pay for the lease was being satisfied by the oil payments. By the "contract of June 30, 1931" (R. 22), which is not in the record, respondents had some undisclosed obligation to give substance to the assignors' right to oil payments by drilling and development work.

The Texas decisions cited by respondents deal with the interest of the assignors, but they do not deny the interest and ownership of the operating lessees. Anyone who has contractual relations with a lessee under which he will receive money depending upon production, may be said to have an interest in production, but that is not a denial of the ownership of the lessee. For purposes of an occupation or production tax the State of Texas may tax the lessee upon all of the production or it may apportion the tax between the lessor and lessee. *Barwise* v. *Sheppard,* 299 U. S. 33. It may adopt

the latter course because they both have an interest in production. The imposition of an income tax, however, upon the owner of the income from oil property depends upon quite different principles. For purposes of an occupation tax the State of Texas may legislate upon the theory that lessor and lessee are engaged in a common venture for their mutual benefit, but Congress has not sought to make such "planned undertaking" or "mining venture" a taxable entity. Moreover, Congress could not, if it would, treat as income the entire amount of oil payments received by assignors. Assignors who have sold out their capital interest in the leases have a cost which must be deducted from the proceeds before there is any gross income. The oil payments do not constitute operating income of assignors. As to them it is not income from the extraction of oil. It is income from the sale of a capital asset, and taxable only to the extent that it exceeds their cost.

Dunn v. *Tennant,* 82 S. W. (2d) 728, shows the extremes to which the respondents' argument based upon Texas decisions would carry. It was there held that one who advanced $5,000 to a lessee as a loan and in consideration was to receive $25,000 of oil, had an interest in the land. Upon respondents' theory the oil necessary to pay the $25,000 did not belong to the lessee, and no Federal income tax could be imposed upon the lessee on account of its production. We submit that the Texas decisions

do not recognize an interest in the lessor to the exclusion of the lessee, and that they do not require that the lessee be relieved of the tax upon the income from its business. The theory has been adopted in this Court that the income is derived from the lease. *Burnet* v. *Coronado Oil & Gas Co.*, 285 U. S. 393; *Gillespie* v. *Oklahoma*, 257 U. S. 501. Since no claim is made that anyone except respondents had an interest in the lease, it appears to be unimportant that others had some rights which the local law recognized as an interest in the land.

In view of the Texas decisions cited in the main brief for the petitioner, and the specific language of the assignment, there is no room whatever for the contention that respondents were not the owners of all the oil which they produced. Had they paid over the stated amount to the assignors after taking it into their own possession, the contention that the entire proceeds did not constitute their income would be quite inadmissible. However, the fact that for convenience and certainty the oil payments were made directly by the Pipe Line Company to the assignors does not change the situation.[2] The payment directly to the assignors was made with respondents' consent, and without their consent the Pipe Line Company would not have been authorized to make it.

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[2] The record shows similar direct payments to a bank (R. 47), but respondents concede the proceeds were for their account.

Respondents' brief is devoted principally to a discussion of what they contend to be conflicting rights to depletion, and they seek to have this case decided by the application of depletion principles. The court below adopted respondents' view, but we submit that the questions of income and of depletion are distinct and should not be confused. In *Poe* v. *Seaborn,* 282 U. S. 101, this Court has pointed out that liability to an income tax depends upon ownership of the income, and that ownership is determined by reference to local law. With respect to depletion, however, this Court held in *Palmer* v. *Bender,* 287 U. S. 551, that the taxpayer's right may depend merely upon whether he has a sufficient economic interest in the property, as to which the Federal Revenue Act is controlling. The fundamental fallacy in respondents' contention lies in the failure to appreciate that depletion is a statutory concept and that in that field Congress is free to ignore ownership and make allowances at pleasure. Accordingly, even if it appeared that through Congressional liberality depletion allowances were made to others, that should have no bearing upon whether respondents own the income from their business.

Respondents say the income cannot be theirs because if it is they are entitled to retain the depletion allowance already made, that their assignors will also be entitled to a depletion allowance under *Palmer* v. *Bender, supra,* and thus that

a result forbidden by *Helvering* v. *Twin Bell Syndicate,* 293 U. S. 312, must necessarily follow. While, as has been stated, we do not believe that the decision of the question in the present case depends upon who is entitled to depletion,[3] in any event we submit that respondents' assignors are not entitled to a depletion allowance upon their oil payments.

Unlike this case, *Palmer* v. *Bender, supra,* did not involve an assignor who had transferred a lease for a stated sum of money. Under the leases there involved, Palmer's partnerships reserved a stated royalty which was to be paid as long as the oil properties continued to produce. Although it is difficult to see any connection between his economic interest in the *produced oil* and the depletion of the *oil in place* (Cf. *Theisen* v. *Robison,* 117 Tex. 489, 510–511), this Court held that Palmer belonged to the class which Congress intended to benefit by the depletion allowance. It would seem that instead of suffering from the extraction of oil, Palmer was actually benefitted by production. His economic interest being exclusively in produced oil, it required production to give any value to his interest. Non-production made his economic interest valueless. Production did not deplete any cap-

[3] It is not without significance that the denial of certiorari in *Comar Oil Co.* v. *Burnet,* 290 U. S. 652, occurred after the decision in *Palmer* v. *Bender,* 287 U. S. 551.

ital interest of his. Because he was allowed depletion, however, it has been assumed by some other courts, erroneously as we think, that all assignors are similarly entitled to depletion. We earnestly submit that the decision in *Palmer* v. *Bender* should not be so extended.

Unlike the assignor there involved, the respondents' assignors have bargained for a stated sum of money, after the receipt of which they will have absolutely no interest in the production from this property. Their interest, we submit, is clearly not of a character which suffers from the operation of the property. The assignors here have limited themselves by a maximum figure which precludes the contention that each barrel taken out *pro tanto* reduces their capital interest.

Their situation is analogous to that of the stockholder who receives a dividend. While it reduces the intrinsic capital value of the shares by an equal amount, the dividend is nevertheless all income. *United States* v. *Phellis,* 257 U. S. 156, 171. The barrel of oil necessary to make the last oil payment clearly does not reduce any remaining interest of the assignors. It is only in a theoretical sense that it can be said that any barrel taken out reduces the possibility that enough remains to make all of the oil payments. That is clearly not true of the first barrel, for it establishes the existence of additional barrels. The same theoretical reduction of intrinsic value is involved in the receipt of dividends

by a stockholder, and in *Lynch* v. *Hornby*, 247 U. S. 339, 346, this Court gave it no effect, saying:

> We do not overlook the fact that every dividend distribution diminishes by just so much the assets of the corporation, and in a theoretical sense reduces the intrinsic value of the stock. But, at the same time, it demonstrates the capacity of the corporation to pay dividends, holds out a promise of further dividends in the future, and quite probably increases the market value of the shares. In our opinion, Congress laid hold of dividends paid in the ordinary course as *de facto* income of the stockholder, without regard to the ultimate effect upon the corporation resulting from their payment.

Moreover, it must be remembered that the assignors' cost is returned to them tax-free in the computation of gross income,[4] and they are taxed only on the portion of the selling price which exceeds cost. Therefore, any reduction of the oil reservoir by extraction involves merely a loss of anticipated profits rather than an actual loss of capital.

The assignors have exchanged their interest in the oil in the ground for an interest in produced oil and have further limited themselves to an interest which is not to endure for the life of the property. Instead of having an interest in the operation of the wells as long as they produce, the assignors now have a definitely fixed maximum interest which is

---

[4] See, *infra*, p. 13.

opposed to conservation and economical operation in the interest of prolonging the life of the property. Their interests are best served now by production, and by prompt and full production. The faster the oil is taken out the quicker will the assignors get their money. Since their interest is in produced oil only, production enhances the value of their interest rather than depletes it.

It is not true here, as this Court said it was in *Palmer* v. *Bender, supra,* p. 558, that "The loss or destruction of the oil *at any time from the date of the leases until complete extraction* would have resulted in loss to the partnerships." [Italics supplied.] While this Court there made no distinction between an actual loss and a mere loss of anticipated profits, it is clear that in this case the suggested destruction would not affect respondents' assignors unless it occurred before the final payment to them, for their connection with the property was limited as to time.

Palmer v. *Bender, supra,* is further distinguishable in that Palmer's partnerships made the discovery of oil. With respect to that matter this Court said (pp. 557–558):

> The statute makes effective the legislative policy, favoring the discoverer of oil, by valuing his capital investment for purposes of depletion at the date of the discovery rather than at its original cost. The benefit of it accrues to the discoverer if he operates the well as owner or lessee, or if he leases it to

> another. It would be an anomaly if that policy were to be defeated and all benefit of the depletion allowance withheld because he chose to secure the return of his capital investment by stipulating for a share of the oil produced from the discovered well through operation by another.

Clearly, that was a consideration which led to the allowance of depletion in *Palmer* v. *Bender*, and it does not apply in this case. The respondents and not their assignors were responsible for the development of the property here involved. The property was not producing at the time respondents and their associates acquired it. (R. 21.) Respondents developed the property, drilled the wells and discovered the oil. (R. 31.) In so far as the depletion allowance is considered as representing a legislative policy favoring the discoverer of oil, it is an argument for making the depletion allowance to respondents alone and not requiring them to share it with the assignors, who have had a merely casual connection with the property as prior owners of the lease.

While *Palmer* v. *Bender* is distinguishable because Palmer discovered the oil and respondents' assignors did not, we would not be understood as conceding that Congress intended to make a depletion allowance to those assignors who did discover oil. Special provision was made elsewhere for their industry and perseverance.

It is clear that respondents' assignors sold an interest in oil and gas wells within the meaning of Section 102 of the Revenue Act of 1932, and if the principal value of the property had been demonstrated by prospecting or exploration and discovery work done by them, they would have been entitled to the preferential rate of tax provided for by that section. A taxpayer claiming the benefit of a deduction must show that he is clearly within the class which Congress intended to benefit. Assignors are clearly provided for in Section 102 and they are not specifically provided for in the depletion provision (Section 23 (l)). Before they are given the benefit of both sections it should be made to appear that there is some basis for such Congressional generosity and solicitude.

Moreover, the respondents' assignors do not account for all of the oil payments as income but only the amount by which the oil payments exceed the assignors' cost. They sold their oil lease and whatever it cost them must be taken out of the proceeds before they have any gross income. *Doyle* v. *Mitchell Brothers Co.*, 247 U. S. 179. Since their cost is taken out before there is any gross income, it appears entirely illogical to permit them to reduce the gross income by a depletion allowance. The theory of depletion is that it is a means of returning the taxpayer's cost, but in the case of assignors the cost has already been returned in the computation of gross income. To permit a de-

pletion allowance in such circumstances is clearly to make a double deduction, for which there is no Congressional sanction.

This record does not show what investment respondents' assignors had made in the property. Therefore, it cannot be said with any assurance that the oil payments represent gross income to them, either in whole or in part. If they have no income from the property they are not entitled to depletion under any circumstances. Accordingly, it appears that respondents' argument with respect to conflicting depletion allowances rests upon pure speculation.

In *Commissioner* v. *Fleming,* 82 F. (2d) 324, the court below made a distinction between the "oil payments" and cash payments, permitting a depletion deduction for the former, but denying it for the latter. If payment out of production is to be the test, the field of favored taxpayers entitled to depletion is limitless. Turnkey contractors commonly receive oil payments as compensation for drilling wells (Cf. *Edwards Drilling Co.* v. *Commissioner,* 35 B. T. A. 341), but it has not been supposed that the form of their payment gives them any claim to a depletion deduction. We submit that oil payments do not indicate a depletable interest, but that the right to depletion allowance depends upon an interest in the lease or the oil in place.

For these reasons, we submit that *Palmer* v. *Bender, supra,* does not require that a depletion

allowance be made to respondents' assignors, and that this Court may properly decide the question of income here involved on its own merits without confusing that issue with depletion.

CONCLUSION

For the foregoing reasons, it is respectfully submitted that the decision of the court below should be reversed.

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MAY 1937.

APPENDIX

Revenue Act of 1932, c. 209, 47 Stat. 169:

SEC. 23. DEDUCTIONS FROM GROSS INCOME.

In computing net income there shall be allowed as deductions:

* * * * *

(l) *Depletion.*—In the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case; such reasonable allowance in all cases to be made under rules and regulations to be prescribed by the Commissioner, with the approval of the Secretary. In any case in which it is ascertained as a result of operations or of development work that the recoverable units are greater or less than the prior estimate thereof, then such prior estimate (but not the basis for depletion) shall be revised and the allowance under this subsection for subsequent taxable years shall be based upon such revised estimate. In the case of leases the deductions shall be equitably apportioned between the lessor and lessee. In the case of property held by one person for life with remainder to another person, the deduction shall be computed as if the life tenant were the absolute owner of the property and shall be allowed to the life tenant. In the case of property held in trust the allowable deduction shall be apportioned between the income beneficiaries and the trustee in accordance with the pertinent provisions of the instrument creating

the trust, or, in the absence of such provisions, on the basis of the trust income allowable to each. (For percentage depletion, see section 114 (b) (3 and (4).)

* * * * *

SEC. 102. SALE OF MINES AND OIL OR GAS WELLS.

(a) In the case of a bona fide sale of mines, oil or gas wells, or any interest therein, where the principal value of the property has been demonstrated by prospecting or exploration and discovery work done by the taxpayer, the portion of the tax imposed by section 12 of this title attributable to such sale shall not exceed 16 per centum of the selling price of such property or interest.

* * * * *

SEC. 114. BASIS FOR DEPRECIATION AND DEPLETION.—

* * * * *

(b) *Basis for depletion.*—

* * * * *

(3) *Percentage depletion for oil and gas wells.*—In the case of oil and gas wells the allowance for depletion shall be 27½ per centum of the gross income from the property during the taxable year, excluding from such gross income an amount equal to any rents or royalties paid or incurred by the taxpayer in respect of the property. Such allowance shall not exceed 50 per centum of the net income of the taxpayer (computed without allowance for depletion) from the property, except that in no case shall the depletion allowance be less than it would be if computed without reference to this paragraph.

* * * * *

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NO. 824

IN THE

Supreme Court of the United States

OCTOBER TERM, 1936.

W. A. THOMAS, Collector of Internal Revenue,
Petitioner,

versus

J. J. PERKINS, ET AL, *Respondents.*

On Writ of Certiorari to the United State Circuit Court of Appeals for the Fifth Circuit.

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INDEX

Page

Opinions Below 1

Jurisdiction 1-2

Statutes Involved 2

Statement Of The Case 2-11

Summary of Argument 11-13

I Perkins cannot be taxed on oil applicable to the oil payment because he did not own same .. 11

II The recent percentage depletion cases definitely established this lack of ownership 11-12

III The Eighth Circuit Court's decision in the Comar Oil Company case is erroneous 12

IV The Pugh case by the Fifth Circuit, and similar cases were overruled by Palmer v. Bender 12

V Other established principles require affirmance of decision 12

VI Economic consequences discussed 13

VII Further discussion of Petitioner's position 13

Argument 13-66

Point I 13-29

Point II 29-40

Point III 40-51

Point IV 51-54

Point V 54-58

Point VI 58-60

Point VII 60-66

Conclusion 66-67

Appendix A Federal Taxing Statutes Involved 68-70

Appendix B Analysis of cases cited in Comar Oil Company decision 71-84

Appendix C Illustration of distinction made by Bureau of Internal Revenue between express reservations and other oil payments 85-88

Authorities Cited

Page

Alexander v. Continental Petroleum Company, 63 Fed. (2d) 927 29

Berry v. Harrell, 83 Fed. (2d) 671 21
Baird v. Commissioner, 65 Fed. (2d) 911 52
Baton Coal Company v. Commissioner, 51 Fed. (2d) 469 75
Beene v. Commissioner, 40 Fed. (2d) 892 52
Blair v. Commissioner, ... U. S. ..., 57 Sup. Ct. Rep. 330, No. 247 ..... 14, 19
Burnet v. Harmel, 287 U. S. 103 23

Caldwell v. Fulton, 31 Pa. St. 484, 71 Am. Dec. 760 ..... 23, 25
Collins v. Atlantic Oil Producing Co., 74 Fed. (2d) 122 26
Comar Oil Company v. Burnet, 64 Fed. (2d) 965 10
Commissioner v. Elliott Petroleum Co., 82 Fed. (2d) 193 ..... 29, 52
Commissioner v. Jones, 82 Fed. (2d) 329 29
Commissioner v. Williams, 82 Fed. (2d) 328 29
Corliss v. Bowers, 281 U. S. 376 24
Crews v. Commissioner (10th C. C. A. Official Citation not Available) 38

Darby-Lynde Company v. Alexander, 51 Fed. (2d) 56 38
Davison v. Commissioner, 60 Fed. (2d) 50 79
Douglas v. Wilcutts, 291 U. S. 1 24
Dunn v. Tennant, 82 S. W. (2d) 728 ..... 20, 21

Eisner v. Macomber, 252 U. S. 189 26

Ferguson, W. P., v. Commissioner, 20 B. T. A. 130 82
Ferriss v. Huffman, 274 S. W. 125 26
Fleming v. Commissioner, 82 Fed. (2d) 324 ..... 10, 29
Fritz v. Commissioner, 76 Fed. (2d) 460 39
Fleming v. Commissioner, 31 B. T. A. 623 42

Green v. Biddle, 8 Wheat 75, 76 23
Greenwood & Tyrell v. Helm, 264 S. W. 221 26
Group No. 1 Oil Co. v. Bass, 283 U. S. 279 65

Hager v. Stakes, 116 Tex. 453, 294 S. W. 835 19
Helvering v. Twin Bell Oil Syndicate, 293 U. S. 312 ..... 12, 35, 36
Herold v. Commissioner, 42 Fed. (2d) 942 ..... 25, 52

Page
Hoeper v. Tax Commissioner, 284 U. S. 206 28
Holliday v. Erwin, 85 S. W. (2d) 355 61
Home Savings Bank v. Des Moines, 205 U. S. 503 28
Hopkins v. Bacon, 282 U. S. 122 ..... 24, 28

International Text Book Company v. United States, 44 Fed. (2d) 254 73

Jefferson Gas Coal Company v. Commissioner, 52 Fed. (2d) 120 77

Kekaha Sugar Company, Ltd. v. Commissioner, 13 B. T. A. 690 81
Knowlton v. Moore, 178 U. S. 41 28

Lynch v. Alworth-Stephens Company, 267 U. S. 364 ..... 23, 24

Merrillat, Chas. H., v. Commissioner, 9 B. T. A. 813 80

Nichols v. Coolidge, 274 U. S. 531 28

Owens v. O'Donohoe, 280 S. W. 842 26

Palmer v. Bender, 287 U. S. 551 ..... 13, 24, 28
Poe v. Seaborn, 282 U. S. 101 ..... 24, 28
Pugh v. Commissioner, 49 Fed. (2d) 76 ..... 10, 32, 51

Reynolds v. McMann Oil & Gas Co., 11 S. W. (2d) 778 19

Sheffielf v. Hogg, 124 Tex. 290, 77 S. W. (2d) 1021 ..... 17, 18
South Vernon Oil Company v. Hopkins, 49 Fed. (2d) 1028 39
Stephens County v Mid-Kansas Oil & Gas Company, 113 Tex. 160, 254 S. W. 290 ..... 16, 19, 21
Stephens v. Stephens, 292 S. W. 290 83
Stratton's Independence v. Howbert, 231 U. S. 399 64

Texas Company v. Daugherty, 107 Tex. 227, 176 S. W. 717 ..... 19, 21
Theisen v. Robertson, 117 Tex. 489 65
Tyler v. United States, 281 U. S. 497 24

United States v. Boston & Providence Railroad Corporation, 37 Fed. (2d) 670 71
United States v. Looney, 29 Fed. (2d) 885 28

Page
United States v. Noble, 237 U. S. 74, 80 22
United States v. Robbins, 269 U. S. 315 ..... 24, 25

Waggoner Estate v. Sigler Oil Company,
118 Tex. 517, 19 S. W. (2d) 27 ..... 19, 49
Waggoner Estate v. Wichita County,
273 U. S. 113 16
Waller v. Commissioner, 40 Fed. (2d) 892 52

Statutes

Revenue Act of 1921:
Sec. 214(a)(10) 29, 30
Revenue Act of 1932:
Sec. 21 68
Sec. 22 ..... 14, 68
Sec. 23(a) 48, 68, 69
Sec. 23 (f) 69
Sec. 114 (b)(3) 63, 70
Revenue Act of 1936:
Sec. 114(b)(3) 36

Treasury Regulations

Regulations 45 (1918 Act):
Article 201 35
Article 203 49
Regulations 94 (1936 Act):
Article 23(m-6) 35, 49

Other Authorities

Commerce Clearing House, 1936 Federal Tax Service,
Vol. I, Para. 204.143, page 834 53
Paul & Mertens Law of Federal Income Taxation,
Vol. 2, Para. 21.18 (1936 Pocket Sup.), p. 204 34
Vol. 2, Para. 21.18, page 702 ..... 34, 53
Texas Syllabi, Vol. 12, No. 2 62
Tiffany on Real Estate (2nd Ed.) Sec. 93, Note 73 22
Tiffany on Real Estate (2nd Ed.) Sec. 2, pp. 4-6 23
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pp. 1647, 1648 23
Thornton on Oil & Gas, (5th Ed.—Willis)
Vol. 2, Para. 304, p. 562 49

NO. 824

IN THE

Supreme Court of the United States

OCTOBER TERM, 1936.

W. A. THOMAS, Collector of Internal Revenue,
Petitioner,

versus

J. J. PERKINS, ET AL, *Respondents.*

On Writ of Certiorari to the United State Circuit Court of Appeals for the Fifth Circuit.

RESPONDENTS' BRIEF

Opinions Below

The opinion of the Circuit Court of Appeals is reported at 86 Fed. (2d) 954 (R. 96). The opinion of the District Court is reported at 15 Fed. Supp. 356 (R. 15).

Jurisdiction

The judgment of the Circuit Court of Appeals was entered December 18, 1936 (R. 100). The jurisdiction

of this Court was envoked by Petitioner under Section 240(a) of the Judicial Code amended by Act of February 13, 1925. Petition for Certiorari was filed on March 17, 1937, and Certiorari granted on April 5, 1937 (R. 101).

Statutes Involved

The Federal Taxing Statutes involved will be found in the appendix, *infra* page 68.

Statement of the Case

This case involves the question of whether under the Revenue Act of 1932 the Respondents can be required to include, as their gross income, without an offsetting deduction, so much of the oil produced from certain leases operated by them, or the proceeds from the sale thereof, as went to their immediate assignors, in accordance with a provision in the assignment to them that one-fourth (1/4th) of the oil produced was to go to their assignors until they had received a specified sum, or oil of a specified value. Such a contractural arrangement is customarily referred to as an "oil payment" and this term will be frequently used hereafter.

The Respondents are husband and wife, joined here because the income dealt with is community income. Since no question relating to this is involved, Mrs. Perkins' connection with the matter will be disregarded and her husband alone referred to hereinafter.

Likewise, the assignment in question (Exhibit 1, R. 21) runs to Faith Oil Corporation. This Company

was owned principally by Perkins and one W. J. Green. In taking the assignment Faith Oil Corporation acted for itself to the extent of one-fourth (1/4th) of the interest acquired; for W. J. Green to the extent of three-eights (3/8ths), and for Perkins to the extent of three-eighths (3/8ths) of the interest acquired (R. 21). The interest so acquired in trust by Faith Oil Corporation was later conveyed to Perkins (Exhibit 5-A, R. 27). Since these facts, too, are immaterial here, we will disregard the joint interest of Faith Oil Corporation and Green with Perkins and treat the matter as if Perkins had been named as the sole assignee in said Exhibit No. 1.

Thus qualified, the pertinent facts are:

Mamie S. Hammonds and Fred P. Branson owned certain oil and gas leases on valuable, but at that time undeveloped, lands in the East Texas Oil Field. They held under ordinary commercial leases providing for the customary one-eighth royalty on oil. These leases are in the Record (Ex. 2, R. 23; Ex. 3, R. 27; Ex. 4, R. 27). On July 24, 1931, they executed an assignment of these leases to Faith Oil Corporation (but for the benefit of that corporation, Green and Perkins, as heretofore stated). The cash consideration recited was Ten Dollars (R. 21), but the actual consideration then paid was One Hundred Five Thousand ($105,000.00) Dollars in cash and Fifty Thosusand ($50,000.00) Dollars in notes, which were later paid (R. 27).

The assignment provided that Branson and Hammonds

"• • • do hereby bargain, sell, transfer, assign and convey all our rights, title and interest in and to said leases and rights thereunder."

But, in stating the consideration, it was provided that the instrument was executed:

"In consideration of the sum of Ten ($10.00 Dollars cash in hand paid by Faith Oil Corporation, a Texas corporation, and of the further sum of $395,000.00 *to be paid out of the oil produced and saved from the hereinafter described lands, and to be one fourth (1/4th) of all the oil produced and saved from the premises hereinafter described until the full sum of* $395,000.00 *is paid.*" (All emphasis throughout is ours unless otherwise noted.)

And, after the granting clause and description of the lands and leaseholds, the instrument further provided:

"As hereinbefore stated, Three Hundred Ninety-five Thousand Dollars ($395,000.00) is to be paid to Mamie S. Hammonds and Fred P. Branson, each to receive one-half thereof, *out of the oil produced and saved from said leased premises,* which payments shall be made by the pipe line company or other purchaser of said oil, and shall be one-fourth (1/4th) of all the oil produced and saved from the above described land, until the full sum of Three Hundred Ninety-five Thousand Dollars ($395,000.00) is fully paid, *which oil payments shall be made direct to the same Mamie S. Hammonds and Fred P. Branson, or their heirs and assigns, one-half to each, by the purchaser or purchasers of said oil, when and as the same is run.* It is under-

stood and agreed that the said Three Hundred Ninety-five Thosuand Dollars ($395,000.00) *is payable out of oil only, if, as and when produced from said lands above described, and said oil payment does not constitute and shall not be a personal obligation of the assignee*, its successors or assigns, nor impose any implied obligation with respect to drilling or development, except in contract of June 30, 1931, the intention being that said Three Hundred Ninety-five Thosusand Dollars ($395,000.00) *shall be paid only out of and to the extent of the proceeds of one-fourth of the oil produced and saved from said premises, if, as and when produced.* It is further agreed and understood that the oil payment herein specified shall bear none of the expenses of the development of said leases or any other burden."

The instrument contained the customary warranty of title. It did *not* purport to reserve or retain any lien (Ex. 1, R. 21-23).

Perkins and associates thereafter developed certain of the leases assigned, drilling twenty-two wells on one lease and eight on each of two others. (R. 31).

In 1933, the tax year here involved, they continued to operate the property and produce oil therefrom, so that Branson and Hammonds received substantial amounts to apply upon their oil payments.

The method of operation was to run the oil from the various wells into tanks upon the various leases, from which tanks the oil was taken by the Pipe Line Companies running and purchasing the oil. Each Pipe

Line Company required and was furnished a division order executed by all parties at interest, including the royalty owner and his assigns. The Pipe Line or Oil Purchasing Company then made periodic payments for the oil run from the properties, making such payments directly and proportionately to interest to the parties executing the division orders. So, at all times, the royalty owner, or his assigns, received payment directly from the Pipe Line Company for their share of the oil, as did Branson and Hammonds and Perkins and the others concerned. At no time did Perkins, or his associates, receive one dollar of the proceeds from the sale of so much of the oil as was applicable to the oil payment.

There are several typical division orders in the record. For example, that addressed to Simms Oil Company (R. 39) is executed by Faith Oil Corporation, Mrs. Hammonds and husband, and Branson. The royalty owners are omitted, evidently because they signed a separate division order. At the date of this instrument, June 17, 1932, record title had not been divided between Faith Oil Corporation, Perkins and Green. The instrument begins:

> "The undersigned *certify and guarantee that they are the legal owners of wells, numbered one and up on the Faith Oil Corporation—J. C. Barret Farm* • • • and until further written notice you are authorized for your own account to receive oil therefrom into your possession, or the possession of any person or corporation designated by you, giving credit as directed below:

Credit to	Division of Int.	P. O. Address
Faith Oil Corporation	20/32 W. I.	Wichita Falls, Texas;
Mamie S. Hammonds and		623 E 18th St. Okla. City, Okla.
Fred P. Branson (One-half each)	8/32 W. I.	Skirvin Hotel, Okla. City, Okla.

Until they receive the sum of $395,000.00 out of the J. C. Barrett and other leases.

Simms Oil Company is hereby authorized until further notice to receive oil from said wells for purchase from the said parties severally in the proportions named, subject to the following conditions:

First: That oil run in pursuance of this division order shall become the property of Simms Oil Company as soon as the same is received into the custody of it or its designated agent.

Second: *The oil received in pursuance of this division order shall be paid for to the party or parties entitled thereto according to the division of interests shown above, at such price as Simms Oil Company is currently willing to pay for oil received from the above described lease on the day of receipt thereof.* Notices of your current price basis and any changes therein are to be addressed to the undersigned at the respective post office addresses shown above. Payments to be made monthly by checks mailed to said party or parties at their respective addresses above set out.

• • • • • • • •

Fourth: The undersigned agrees to furnish Simms Oil Company with satisfactory abstracts and other evidence of title at any time on demand and in event of failure to so furnish such evidence

of title, or in case of any adverse claim of title, to furnish to Simms Oil Company upon demand a suitable and satisfactory bond executed by a surety company authorized to do business in Texas, indemnifying Simms Oil Company against such claim or claims, and that Simms Oil Company may retain the purchase price of the oil without interest until furnished such bond or until the dispute as to ownership is settled satisfactorily to said company.

* * * * * * * * *

(Signed) Faith Oil Corporation, Inc.,
W. J. Green, President,
Mamie S. Hammonds,
O. O. Hammonds,
Fred P. Branson."

Under customary oil field practice, Perkins and associates could not have collected for any portion of the oil applicable to the oil payment, except with the written consent of Branson and Hammonds (R. 48).

At the time of the trial, Branson and Hammonds had received approximately one-half of what was coming to them under the oil payment, and it was then probable that they would receive the balance within the next two and one-half years (R. 48). The first oil had been produced in 1931 (R. 31), so it will be approximately the close of 1938 before Branson and Hammonds receive all their share of the oil.

In making his tax return for 1933, Perkins did not include as his income so much of the oil, or its proceeds, as went to Branson and Hammonds, but, upon audit of these returns, these amounts were so included by the taxing authorities (R. 48). In so doing, percentage de-

pletion was allowed against the additional amounts so included, which of course Perkins had not claimed because he had not included these amounts as a part of his gross income. The theory upon which the Commissioner acted is disclosed by the following excerpt from his letter rejecting the refund claims: (R. 61)

> "A review of the case discloses that in accordance with the terms of the contract, whereby a working interest in certain East Texas oil and gas leases was acquired for cash and additional payments to be made out of a fraction of the oil produced, oil payments of $19,229.03 made during 1933 have been included in taxable income subject to percentage depletion and also in leasehold cost returnable through cost depletion. This action is in accordance with the decision of the United States Circuit Court of Appeals for the Eighth Circuit in the case of the Comar Oil Company, 64 Fed. (2d) 965, certiorari denied by the United States Supreme Court, 54 S. Ct. 69, in which it was held that where certain oil and gas leases were transferred to the petitioner by assignments in consideration for a certain amount of money to be paid partly in cash and partly out of oil and gas as produced from the leased property, the royalties paid as deferred payments in 1923 constituted taxable income to the petitioner and also represented capital transactions not deductible as expenses. The treatment of this item in the revenue agent's report is therefore approved by this office."

Perkins paid the tax, filed claims for refund and, upon their rejection, instituted suit in the United States District Court for the Northern District of Texas

against the Collector to whom the payments were made. The record presents no question as to compliance with the requirements requisite to bring the suit.

In the Trial Court it was proven that the long established practice of the Bureau of Internal Revenue, was not to require the operator of an oil and gas lease to include, as a part of his income, the royalties payable in kind to the lessor; that where royalties were payable in cash the operator included the proceeds from the sale of all the oil, but took as an offsetting deduction the amount of the royalties paid. (R. 65-66; 75-76).

The Respondents made their income tax returns upon a cash receipt and disbursement basis. (Alleged (R. 5); admitted (R. 10).) The Respondents admitted that, if they prevailed in their contention that the sums going to Branson and Hammonds should not be included in their income, the depletion allowed them should be correspondingly reduced (R. 59).

The Trial Court held against Perkins' contention that the amounts which went to Branson and Hammonds should be excluded from his income. The Trial Court treated the oil payments as a debt; the assignment in question as conveying to Perkins and associates the entire leasehold, and all oil applicable thereto. As stated by the Circuit Court, the Trial Court preferred the reasoning of the *Pugh* case (5th C. C. A.) 49 Fed. (2d) 76, and the *Comar Oil Company* case by *the Eighth Circuit*, 64 Fed. (2d) 965, to the later decision of the Fifth Circuit in the *Fleming* case 82 Fed.

(2d) 325. The Trial Court indicated that Branson and Hammonds as well as Perkins might be allowed depletion with respect to the sum in question.

Upon appeal, the Circuit Court treated the matter as concluded by its decision in the *Fleming* case and this Court's decision in the *Palmer* case, and recognized that its *Pugh* and *Palmer* decisions had been overruled by this Court's decision in *Palmer v. Bender.* That Court held, in substance, that Branson and Hammonds were not creditors; that what they received was income from the production of oil and not purchase money; that Perkins owed them only the duty to submit to a division of the proceeds derived from the mining operation and that, to be consistent, the matter should be decided in accordance with the principles which it had applied in its recent decisions involving depletion.

Upon the Government's claim that this opinion conflicted with that of the 8th Circuit Court in the *Comar Oil Company* case, *supra*, this Court granted certiorari.

SUMMARY OF ARGUMENT

I

That portion of the oil produced, or the proceeds from the sale thereof, which went to Branson and Hammonds, cannot be included in Perkins' gross income because it did not belong to him, either practically or legally.

II

Those decisions which hold that taxpayers similarly

situated to Branson and Hammonds are entitled to an allowance for percentage depletion based upon the amount which they receive to apply upon such oil payments are decisive of the question; for, to reach that conclusion, it must be determined that such sums are gross income derived by such oil payment holders from the extraction of the oil or gas. No sum can simultaneously be the income of two taxpayers from the same source. This Court's decision in *Helvering v. Twin Bell Oil Syndicate*, 293 U. S. 312, compels the same conclusion.

III

The *Comar Oil Company* case—apparently conflicting with the decision below—presents some substantial factual differences, and, in any event, it was based upon a serious misconception of fundamental tax practices and of applicable statutory provisions, and its conclusions are not supported by the authorities cited in the opinion. The basic holding of this Court in the *Palmer* case was misunderstood.

IV

It is now recognized that the *Pugh* case and other similar cases, upon which the Government must rely here, were in effect overruled by this Court's decision in the *Palmer* case.

V

Various other well established principles support the decision below.

VI

The economic consequences of a holding favorable to the taxpayer were misunderstood by the Trial Court.

VII

Petitioner's brief does not meet the issues involved, and the authorities cited do not support his conclusion.

ARGUMENT

I

Our basic contention is that Perkins never acquired an interest in so much of the oil as will be necessary to satisfy the "oil payment" of such a nature as to constitute the delivery of the same by him in accordance with the contractual requirement, a part of his gross taxable income. This is *not* solely because of Texas theories about ownership of oil in place. In Texas, the Courts might justify the conclusion because there title to so much of the oil as was and will be necessary to satisfy the oil payment never passed to Perkins. In other States, for example, Louisiana, (selected because the property in *Palmer v. Bender* 287 U. S. 551, was located there), the conclusion would be justified because Perkins never acquired "legal control" of that much of the oil. We submit that the controlling reason is that, under the practical view adopted in tax matters, Perkins did not own sufficient "rights" in the oil or its proceeds to constitute the same, upon production and disposition, his income. Perkins should not be taxed with respect to this oil because he did not own it, either from

the standpoint of State law or when viewed from the standpoint of Federal taxation.

If Perkins derived any taxable gain from the one-fourth of the oil produced which went to Branson and Hammonds, this gain must be reported and taxed because of the all-inclusive definition of "gross income" [1] in the statute; if not, he should not, and cannot, be taxed thereon because, although all "gain" is included in the definition, nothing but "gain" is included.[1a]

If Perkins' relation to this oil was that of an owner, and his relation to Branson and Hammonds that of a debtor, then it would follow, necessarily, that the production and delivery of this oil to apply on his obligation was an income producing transaction. We do not contend that actual physical receipt of income is necessary to support a tax thereon; we recognize that the "short-cut" method of payment by the purchaser of the oil to Branson and Hammonds would produce

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[1] Section 22(a) Revenue Act of 1932, set out in full at page 68 Appendix.

[1a] Because the basic factor in the concept of income is ownership, no single item can, we submit, be simultaneously the income of two people. The principles applied to determine the taxability of assigned income, discussed by this Court in its recent decision of *Blair v. Commissioner*, ... U. S. ...., decided Feb. 1, 1937, do not conflict with this. Thus if the holder of a debt is assigned the rent from a building to pay interest due him, both he and the debtor who owns the building receive income by the short-cut process of paying the rent directly to the holder of the debt, but only one receives "rent,"—the other receives "interest." The building owner has an off-setting deduction for interest paid.

income to Perkins if it were *his* oil so paid for, and if the proceeds were applied upon *his* debt. But, by precisely the same line of reasoning, if this one-fourth of the oil did not belong to him, if he did not owe a debt to Branson and Hammonds, and receive credit thereon through the sale of this oil, he cannot be taxed thereon.

There are three tests that might be applied to solve this question:

(1) The principles which would be applied by Texas Courts;

(2) The principles which would be applied in other States where different theories are applied to transactions relating to oil and gas; and

(3) The practical view, capable of nation-wide application, which this Court has consistently applied in passing upon Federal tax problems.

We believe the same result is reached under each of these tests.

First, it should be observed that the Government's basic contention is that, by virtue of the broad language in the granting clause of the assignment, Branson and Hammonds parted with all of their ownership rights in the leaseholds and the oil to be produced therefrom, and converted their position into that of a creditor entitled to receive, contingently, a debt payment.

Under Texas law, this position cannot be supported. The question has ordinarily arisen in the interpretation of leases, as distinguished from assignments or subleases, and chiefly in connection with ad valorem tax

cases. Such instruments employ varying terms:—Some "let and lease" the land for mining operations; some "bargain, grant, sell and convey" all of the oil and other minerals, with the right to use the land for mining purposes; some provide for a royalty payable in kind, some for cash measured by the value of a specified fraction of the minerals; some give the lessee the option to pay royalties in kind or in cash; some treat the royalty as a reservation, some as a payment back; practically all refer to the royalty as the consideration, or a part of the consideration, for the grant.

At one time, the applicable decisions were somewhat confused and there was plausible support for the proposition that, if the lessor did not expressly reserve a portion of the oil, title to all of the oil passed to the lessee. That was the state of the decisions when *Waggoner Estate v. Wichita County*, 273 U. S. 113, was before this Court and, no doubt, led to the expression in that opinion to the effect that title to all of the oil passed to the lessee.[2] But the situation has now been

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[2] The *Waggoner Estate* case was decided by this Court on January 3, 1937. This Court referred to *Stephens County v. Mid Kansas Oil & Gas Company*, 113 Tex. 160, 254 S. W. 290, and said (page 118):

> "In the absence of controlling authority in the Texas Courts, we can find in the terms of the leases themselves no basis for the contention that the lessor granted or conveyed away his entire interest in the oil. The case of *Stephens County v. Mid-Kansas Oil & Gas Co.*, supra, is relied upon by appellants, but in that case the lease, similar in other respects to those now under consideration, provided that the lessee at his option should pay the stipulated royalties in oil or

clarified by the Supreme Court of Texas in *Sheffield v. Hogg*, 124 Tex. 290, 77 S. W. (2d) 1021, and it is settled that regardless of verbiage, the grantor in such an instrument has and retains an interest in the minerals equivalent to the share which he is to receive, or which measures his cash payment.[3] The same result was

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cash. It thus conferred on the lessee the essentials of ownership—possession, with unrestricted power of appropriation and disposition of the oil. The lessee was therefore properly taxed as owner."

We point out, in this connection, that the question in the *Stephens County* case was whether the Oil Company was taxable upon its interest under the oil and gas lease as real estate. The question of whether the royalty owner was also taxable upon his interest in the lease as real estate was not directly involved.

[3] In *Sheffield v. Hogg, supra*, the lease in question purported to "transfer and set over, sell and convey (under the terms and conditions hereof and for the period and purpose herein set forth) all of the gas, oil, sulphur and other minerals and mineral substances on, in and under the hereinafter described land." The royalty provision was that the lessor should "have the following royalty on the gross production of oil or gas wells on said land, to-wit: one-eighth of all oil and one-eighth of all gas, and the first party's one-eighth royalty interest in the oil and gas manufactured from said land to be paid over to him by second party at the end of each month, or whenever second party shall receive pay therefor."

The basic contention of the Hogg heirs in this case was that the value of their royalty interest under this instrument could not be taxed to them as real estate in the County where the land was situated. But the Supreme Court denied this contention for reasons which are controlling here. The Court said:

reached by the Supreme Court of Texas when it considered a warranty deed purporting to convey the land in fee simple, but providing that the grantor was to re-

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"Endeavoring to reach the true purpose and intent of parties, we can draw no substantial difference, so far as taxation is concerned, between an agreement *excepting* from a grant or a lease a certain fractional portion of minerals, or an agreement *reserving* the same portion, or an agreement that the lessor '*shall have*' or, rather *shall continue to have* the same portion, or an agreement that the lessees *shall yield or shall deliver to the lessor* exactly the same portion. In either instance, the title to the specified mineral portion is intended to remain or vest, and does actually remain or vest, in the lessor. It logically can make no difference, as may have been intimated in this justice's and in other far greater jurist's reasoning, whether the oil is retained by the lessor as oil and gas, readily convertible into cash on the market, or whether the lessee is given a power to sell *all* of the oil or gas, always accounting for a fixed royalty portion to the lessor. Sound principle, supported by the highest authority, goes further and compels us to accede to the proposition that dealing with oil and gas or dealing with solids in place, like sulphur, lignite, salt, coal or lime, the lessor owning the entire fee-simple title to the land, and his assigns, who may have been careful to secure to themselves, their heirs or assigns (by exception or reservation or by contract for '*having*' or yielding or paying, or for delivery, or by what-not-similar contractual clause), the right to a portion of the proceeds or profits derived from the lessee's or his assigns' authorized sale of the minerals, throughout the duration of a determinable fee, which may be perpetual, have and own a fee simple interest in land, or at least have a right belonging or appertaining to the horizontal strata of the land in which the minerals are embedded. • • • •

ceive a certain share of the oil, if the grantee or his assigns subsequently developed the property.[4]

• • • • We therefore hold that all the property interests of ascertainable value, secured to the lessor or their assigns under the Hogg-Hamman lease, are subject to taxation as real estate in the county wherein the land lies, as adjudged by the District Court." (Italics by the Court.)

An examination of the following cases: *Texas Co. v. Daugherty*, 107 Tex. 227, 176 S. W. 717; *Stephens County v. Mid-Kansas Oil & Gas Co.*, 113 Tex. 160, 254 S. W. 290; *Hager v. Stakes*, 116 Tex. 453, 294 S. W. 835; *Waggoner Estate v. Sigler Oil Co.*, 118 Tex. 517, 19 S. W. (2d) 27; *Reynolds v. McMans Oil & Gas Co.*, 11 S. W. (2d) 778, by the Commission of Appeals, in connection with *Sheffield v. Hogg, supra*, will show how the theory under discussion was developed by the Texas Courts and finally fixed as shown in the above quotation from *Sheffield v. Hogg.*

[4] See *Hager v. Stakes*, 116 Tex. 453, 294 S. W. 835. We believe that the construction placed by the Supreme Court of Texas upon the deed involved in this case (there were several instruments besides the deed under consideration) announces a correct and controlling principle of construction, in addition to illustrating the Texas rule under discussion. This deed was to J. M. Guffey Petroleum Company. It recited a cash consideration paid and the further consideration of "one-eighth of seventeen-eighteenths of all petroleum which said J. M. Guffey Petroleum Company, its successors and assigns hereunder may produce and save from the land above described, such portion of the petroleum to be delivered free of expense to me, the said Lee Hager, my heirs or assigns, at the well or at my or their option to any pipe line which may connect to the well." Hager owned a 17/18ths interest in the land prior to the execution of the deed and the Supreme Court announced its

The Texas case most directly in point, because it involves an "oil payment" rather than ordinary royalties, is *Dunn v. Tennant*, 82 S. W. (2d) 728, now pending in the Supreme Court of Texas on writ of error. It was there held that an instrument, executed in consideration of money advanced to a lessee, which provided that one advancing the money was to receive a fraction of the oil until oil of a specified value, materially exceeding the amount of money advanced, had been received, conveyed an interest in the land and did not create a debtor-creditor relationship. This case is all the more convincing because the rights did not arise in

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conclusion that the deed "does not grant or convey all of the grantor's undivided seventeen-eighteenths of the petroleum in this 150 acres of land, despite the positive terms of the granting and habendum clauses." This, the Court said, was because the instrument disclosed that its "dominant purpose" was to make impossible any disposition of the 1/8th of 17/18ths of this oil, except its delivery to Hager or his assigns. "Hence no matter how poorly expressed, their being words disclosing such purpose, there is excepted from the grant 1/8th part of 17/18ths of the petroleum. It is obvious that the instrument negatives the view that the obligation to deliver a portion of the oil was intended to be a mere personal covenant of the lessee or its assigns. Likewise, the obligation was not meant to inure to the personal benefit of the lessor. It was meant to benefit the owner of an estate in the land and to run permanently with the land."

So, in our case, the covenant in favor of Branson and Hammonds ran with the land. Perkins, as well as the original party to the instrument, Faith Oil Corporation, could assign their interests and be freed from all further obligation.

a conveyance or assignment in the chain of title.[5] This case was cited with approval by the Fifth Circuit in *Berry v. Harrell*, 83 Fed. (2d) 671.

These Texas decisions furnish an appropriate guide for the interpretation of the instrument before this Court. It is primarily a problem of conveyancing and construction. Under the decisions referred to above, controlling effect cannot be given to any one clause in the instrument. It must be looked at in its entirety, and if such an examination shows that, after execution and delivery of the instrument, the grantor still retains the exclusive right to a share of the oil, or the exclusive right to the proceeds from a sale of that share of the oil; he has not sold that much of the oil but continues to be the owner thereof. So tested, Perkins did not acquire, and Branson and Hammonds did not sell, one-fourth of the oil.[6]

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[5] Clearly under Texas Law Branson and Hammonds, prior to the assignment to Perkins owned 7/8ths of the oil under the land. Necessarily, they continued to own all with which they did not part under a fair construction of the instrument. In *Dunn v. Tennant*, the lessee there likewise owned all of the lessee's share of the oil and gas and, clearly, his dominant purpose was to secure and repay an advance of money made by Mrs. Dunn, who had no previous connection with the title.

[6] As illustrated by *Texas Company v. Daugherty*, 107 Tex. 226, and *Stephens County v. Mid-Kansas Oil & Gas Company*, 113 Tex. 160, 168, a conveyance of oil in place may be made either by an instrument which expressly so states, or by one which confers rights of possession, use and enjoyment. Texas Courts merely look at the substance and now hold that each creates a

If we examine the question in the light of the decisions of those States which do not recognize that oil or gas in place is capable of transfer and sale apart from the fee, we arrive at the same result from a tax standpoint. Under such a theory, the lessee did not acquire title to the oil in place, so, regardless of verbiage, he could not sell it. Under this theory, title to the oil in place remains in the lessor. The lessee acquired the

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determinable fee. See cases cited foot note page 19 hereof. Also *United States v. Noble*, 237 U. S. 74, 80. Prior to the execution of the instrument, Branson and Hammonds had obtained from the lessor the right of possession for oil purposes and rights in or ownership to 7/8ths of the oil. They transferred to Perkins their right to possession, and gave him control over development and producing operations—just as the lessor had given them control over these operations, but they did not give him the right to appropriate or in anywise dispose of 1/4th of the 7/8ths of the oil, and he, therefore, never acquired from them ownership of this oil any more than they, in turn, had acquired ownership of the 1/8th royalty from the landowner by virtue of the original lease. Perkins did not have what this Court termed the essentials of ownership in the *W. T. Waggoner Estate case*, supra: "Possession, with unrestricted power of appropriation and disposition of the oil." Perkins has possession, but his power of disposition and appropriation was limited and did not include either the royalty owner's 1/8th or Branson and Hammond's 1/4th. There was a subdivision of ownership—not a complete transfer, and while it is probable that Branson and Hammonds' interest in the oil will be terminated prior to that of the royalty owner, it is possible for their interest to last equally as long. This possibility of termination is what makes the estate a determinable fee. *Tiffany on Real Estate*, (2nd Ed.) Sec. 93, Note 73.

exclusive right to operate and to appropriate, when produced, a specified portion of the oil. To this oil, he acquires title when produced. But here, by the self-same instrument by which Branson and Hammonds transferred to Perkins control of operations. they expressly, and in the clearest possible language, provided that, when and as the oil, then undiscovered and unproduced, reached the top of the ground and became, under this theory, capable of ownership and division, one-fourth should be delivered to their credit in exactly the same way that the royalty owner was to receive his share. At no point of time did Perkins have or acquire the rights of an owner as to this portion of the oil. He was obligated to produce it with his own share, but in no way could he benefit by it.[7]

This Court has always refused to apply peculiar State laws to Federal Taxing Statutes of national application, when the taxing statute contained its own standards and criteria. *Burnet v. Harmel*, 287 U. S.

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[7] Of course, when reference is made to an estate in land, it is merely descriptive of the rights which the holder of that estate has. *Tiffany on Real Estate*, Sec. 2, pp. 4-6. The right of Branson and Hammonds to 1/4th of the oil could be conveyed by them or taken in execution against them, and Perkins could not cut these rights down. The right continues for an indefinite term and may continue as long as oil will be produced. In just the same way that he who has the profits of the land owns the land, we say that he who retains a share of the profits of the land retains an interest in the land. *Tiffany on Real Estate* (2d Ed.) Vol. 2, Page 1647, 1648; *Green v. Biddle*, 8 Wheat 75, 76; *Caldwell v. Fulton*, 31 Pa. St. 484, 71 Am. Dec. 760; *Lynch v. Alworth Stephens Company*, 267 U. S. 364.

103, is an example. Cf. *Poe v. Seaborn*, 282 U. S. 101, and *Hopkins v. Bacon*, 282 U. S. 122. Especially has this Court applied this principle in tax cases involving oil or other minerals. Thus, in *Lynch v. Alworth Stephens Company*, 267 U. S. 364, this Court refused to let the fact that under Minnesota law, a lessee, who had sub-let ore lands for cash royalties, might not own any of the ore in place, prevent this Court from recognizing that he had a valuable property right which was depleted by the production of the ore, entitling him to a depletion allowance based upon his income from the property. The same disregard of technical distinctions and the terminology employed by State Courts was shown in *Palmer v. Bender*, 287 U. S. 551, discussed fully elsewhere. And this Court has, on many other occasions, disregarded "refinements of title" and looked, instead, at the practical situation, the actual benefits and the actual command which the person claimed to be taxable might exercise over the property or fund taxed.[8] We venture to say that the use by this Court in the *Palmer* case of the phrase "economic interest" was prompted by a desire to view the matter broadly and practically, and to establish a standard which could not be varied because of the differing views which State Courts might take of the situation, and the various classifications which they might make of the parties and their rights.

Looking at the present situation from this stand-

[8] *Tyler v. United States*, 281 U. S. 497; *Corliss v. Bowers*, 281 U. S. 376; *United States v. Robbins*, 269 U. S. 315; *Douglas v. Wilcutts*, 291 U. S. 1.

point, we find that Perkins had no "rights" in the one-fourth of the oil applicable to the Branson-Hammonds oil payment. Perkins' conveyance would give no one control of or economic benefits from that one-fourth of the oil. He could not mortgage it; he had no equity in it. It could not be taken for his debt. He could not sell this one-fourth of the oil as produced. The instrument did not give him this right; the long-established custom in the oil business recognized this and the signature of Branson and Hammonds to the "division order," (actually the contract under which the oil was sold) was always required. A recognized test to determine ownership is to determine upon whom the loss would fall if the subject matter of the test were lost or destroyed through no fault of any one.[9] Clearly, in such a case, the loss would fall on Hammonds and Branson. Mr. Justice Holmes used the test of determining for whose debt the property could be taken.[10] Ownership, without rights such as these, is an impossible conception, and when these rights are fixed in one person under a fair construction of the instrument, no language can vest real ownership in another.[11]

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[9] See Judge Dawkins's dissenting opinion in *Herold v. Commissioner*, 42 Fed. (2d) 942. We believe that the theory developed by Judge Dawkins in this case, which was closely related to the Palmer case on the facts, also closely accords with the theory upon which this Court later decided the Palmer case.

[10] *United States v. Robbins*, 269 U. S. 315 (The first California Community Property Income Tax case).

[11] "The general power of disposal without liability to account, is equivalent to ownership itself." *Caldwell v. Fulton*, 31 Pa. St. 483, 488, 71 Am. Dec. 760.

Each right of ownership that Perkins did not have —and he had none whatever, we submit—was in Branson and Hammonds. They could sell the right to receive the oil, they, only, could, and did, sell the oil when produced; they, only, could, and did collect for it; the interest involved was subject to seizure and sale for their debts. True, Perkins had the burdens of producing, just as he had the same burdens with respect to the one-eighth royalty—but benefits, not burdens, determine ownership.

Nor can it be fairly said that Perkins' burdens and the benefits accruing to Branson and Hammonds arose out of a debtor-creditor relationship and some thing equivalent to a pledge or lien. Certainly there was no express lien or pledge. Nor was there any personal obligation to pay or cause to be paid. If, after a fair test, oil had not been found, Perkins could surrender the lease without liability.[12] One cannot so relieve himself of a debt, we are certain. Without a debt, there can be no lien or pledge. Any debt can be paid prior to maturity, if the payor seeks no discount. But this agreement, binding on both parties, said the payments were to be made "*only* as, if and when oil was produced." Branson and Hammonds could have refused cash, and in many cases, because of wide differences in tax liability, a tender of cash would be refused. Progressive

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[12] *Owens v. O'Donohoe*, 280 S. W. 842, *Greenwood & Tyrrell v. Helm*, 264 S. W. 221; *Ferris v. Huffman*, 274 S. W. 125, by Commission of Appeals; *Collins v. Atlantic Oil Producing Company* (5th C. C. A.), 74 Fed. (2d) 122.

surtaxes and depletion allowances would in many cases make such a refusal extremely profitable.

We submit that, from a practical standpoint, the situation now before the Court is like that of a share-cropper. The tenant who agrees to deliver one-fourth of the cotton produced, or one-fourth of the proceeds from its sale, is not considered a debtor in the ordinary sense of the term. He has the burdens, he has a large measure of control, he may be authorized to sell and collect the proceeds, but as long as no obligation arises, except as and if crops are harvested, and then only to the extent of a share of the harvest; if he must submit to a division of the proceeds, but need not make up any deficiency, he is not a debtor. And, most important, no one has ever suggested that such a tenant must include the proceeds of the crop accruing to his landlord as a part of his—the tenant's—gross income and that, if he adopted a system of accounting under which this was done, he would not deduct as a current expense, the crop rents so paid.

In final analysis, the question is to be determined by fundamentals—who derives income from, who obtains and owns gain from the one-fourth of the oil? Gain, without ownership cannot exist.[13] The gain is the in-

[13] In *Eisner v. Macomber*, 252 U. S. 189, this Court not only said that income was the gain derived from capital, from labor, or from both combined, but this Court went on to say that such gain must be derived by the taxpayer "for his own separate use, benefit and disposal." Here Perkins owed no debt to Branson and Hammonds (See the authorities cited in foot note 12), and, certainly, he derived no benefit from, and he could

come "of" that person who so owns it.[14] This Court has frequently so held,—applying the principle that taxes are usually, if not necessarily, imposed by reason of ownership.[15] As late as January of this year, this Court again applied the principle, saying:

> "In the instant case, the tax is upon the income as to which, in the general application of the Revenue Acts, the tax liability attaches to ownership. See Poe v. Seaborn, supra; Hoeper v. Tax Commissioner, 284 U. S. 206." *Blair v. Commis-*

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not use or dispose of the 1/4th of the oil going to Branson and Hammonds.

[14] This is the basis of this Court's decision in the Community Property Cases. See *Poe v. Seaborn*, 282 U. S. 101; *Hopkins v. Bacon*, 282 U. S. 122. In these cases the wife's share of community income was held to belong to her, regardless of the large measure of control which the husband exercised over this income in the ordinary case.

[15] This Court said in *Home Savings Bank v. Des Moines*, 205 U. S. 503, that all taxes are usually, if not necessarily, based upon the property of the person taxed—not upon the property of someone else. In *Knowlton v. Moore*, 178 U. S. 41, it was pointed out that a tax measured by the property of someone else would be of doubtful validity, and would probably "transcend those fundamental limitations" implicit in the Constitution. In the later cases of *Hoeper v. Tax Commissioner*, 284 U. S. 206, and *Nichols v. Coolidge*, 274 U. S. 531, Taxing Statutes were held invalid for this very reason. The Fifth Circuit said, in *United States v. Looney*, 29 Fed. (2d) 885: "But rents or royalties are not properly included in the income of one who did not own, receive or control them; the ownership thereof being vested in another when they accrued."

sioner, ... U. S. ....., 57 Sup. Ct. Rep. 330, No. 247, 1936 Term.

We believe this rule governs here and requires an affirmance of the Circuit Court's decision.

II

The question here presented was necessarily decided in accordance with the view of the Court below by *Palmer v. Bender*, 287 U. S. 551, and by *Fleming v. Commissioner*, 82 Fed. (2d) 324, *Commissioner v. Elliott Petroleum Company*, 82 Fed. (2d) 193, and similar cases, even though the right to depletion allowances was the primary question involved in those cases.[16] In the *Palmer* case, "discovery" depletion under the Revenue Act of 1921 was involved. This Act limited the depletion allowance to "net income from the property."[17]

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[16] *Commissioner v. Jones*, 82 Fed. (2d) 329; *Commissioner v. Williams*, 82 Fed. (2d) 328, both decided by the Fifth Circuit with *Fleming v. Commissioner; Alexander v. Continental Petroleum Company*, 63 Fed. (2d) 927.

[17] The Revenue Act of 1921 contained the following provision regarding depletion: "Sec. 214(a) That in computing net income there shall be allowed as deductions: * * * * (10) In the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case, based upon cost including cost of development not otherwise deducted: *Provided*, that in the case of such properties acquired prior to March 1, 1913, the fair market value of the property (or the taxpayer's interest therein) on that date shall be taken in lieu of cost up to that

This means, of course, the taxpayer's net income from the property. Since this Court held that Palmer was entitled to a very substantial amount of "discovery" depletion, it was necessarily held that he had at least an equivalent amount of net income "from the property." Otherwise, regardless of the nature of his interest in the property, no allowance could have been awarded. But in that case the Government contended that the assignments in question divested Palmer of all interest in the property and its oil reserves;[18] while Palmer contended

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date: *Provided further*, That in the case of mines, oil and gas wells, discovered by the taxpayer, on or after March 1, 1913, and not acquired as the result of purchase of a proven tract or lease, where the fair market value of the property is materially disproportionate to the cost, the depletion allowance shall be based upon the fair market value of the property at the date of discovery, or within thirty days thereafter; *And provided further, That such depletion allowance based on discovery value shall not exceed the net income, computed without allowance for depletion, from the property upon which the discovery is made*, except where such net income so computed is less than the depletion allowance based on cost or fair market value as of March 1, 1913; such reasonable allowance in all the above cases to be made under rules and regulations to be prescribed by the Commissioner, with the approval of the Secretary. In the case of leases the deductions allowed by this paragraph shall be equitably apportioned between the lessor and lessee."

[18] This Court stated that the assignment to the Ohio Oil Company made by the partnership, of which Palmer was a member, contained the following language: "* * * does sell, assign, set over, transfer and deliver * * * unto the Ohio Oil Company" the leased premises,

that, under Louisiana law, the instruments were subleases. This Court refused to pass upon or to be controlled by these views, or by the terminology which a State Court might apply. Instead, it was pointed out that Palmer continued to have "legal control" over a share of the oil, "a right to share in the oil produced," he, therefore, had an "economic interest" in the oil; his income was "derived from the extraction of oil" which constituted, in the ground, a common "reservoir" to which he, his assignees and the landowner must look for a return of their capital; the loss or destruction of this reservoir would be suffered jointly by Palmer and all concerned; he, therefore, was entitled to depletion to offset against the income he derived from the transaction.

After this decision, the Fifth Circuit, which had theretofore followed the view urged by the Government in the *Palmer* case, refused again to hold that, under instruments like that here involved, the assignor had divested himself of all interest in the property.[19] In-

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and provided as the consideration a "present payment of a cash bonus, a future payment to be made 'out of one-half of the first oil produced and saved' to the extent of $1,000,000.00, and an additional 'excess royalty' of all of the oil produced and saved." The Court also stated that the other assignment involved, in favor of Gulf Refining Company, was a similar document. Thus the granting language was at least as broad as that contained in the assignment to Perkins.

[19] The earlier cases by the Fifth Circuit are briefly referred to at page 51 hereof, and it is there shown that it has been generally recognized that these decisions were overruled by this Court's decision in the *Palmer* case.

stead, in cases involving the right of the holder of oil payments, indistinguishable from those outstanding against Perkins' property, to percentage depletion, (which right the Government contested upon the theory that the assignor holding the oil payment had divested himself of all interest in the property) that Court held that what such an assignor really sold was the leasehold and the right to all of the oil, except that necessary to satisfy the oil payment, which latter amount was not sold.[20] Therefore, the Fifth Circuit held such an as-

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[20] The language involved in the *Fleming* case is almost identical with that contained in the assignment to Perkins. The contract provided that the lessee owners contracted to sell and convey, by proper assignment, and transfer all their entire interest in and to oil and gas lease and all oil, gas and other minerals produced therefrom. The consideration provided for was $1,000,000.00 in cash "and $1,000,000.00 out of one-fourth of all oil, gas and other minerals produced from said working interest in said lease, being one-half of the interest hereby conveyed; said $1,000,000.00 is not and never shall be a personal obligation or liability against the second party, but shall be paid only out of the products if, as and when produced and sold from the said premises." The Court said as to the Commissioner's contention: "In this case, the Commissioner contends that in the sale of each lease the whole amount paid, whether in cash or from production and sale of oil, was purchase money and subject to no depletion, pointing to *Pugh v. Commissioner*, 49 Fed. (2d) 76." The Court said: * * * * the payments from oil were not the independent capital of the of the purchaser, but represent a part of the oil reserve. The purchaser was not bound personally for these payments. If the oil ran short or proved non-existent, the taxpayer

signor-oil payment holder was entitled to percentage depletion on the amount received to apply upon the oil payment, he receiving to that extent income from the property, in which, on that account, he had an economic interest; that is, a right to share in the oil produced.[20A]

A recognized authority of Federal Taxation states: "Where the income is, there the depletion should be also."[21] In other words, the one taxed upon income de-

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was a proportional loser. *While the contract was phrased as though the lease and all the oil were sold, and as though the proceeds were to be paid back to the seller, the real essence of the transaction was that the lease was sold and all the oil except that whose proceeds were to come to the selling taxpayer.* The conveyance executed when the cash was paid might very appropriately have *reserved* or *excepted* sufficient oil from that thereafter run to pay the agreed sum. * * * But it was in effect an exception or reservation of oil. *The thing sold for the cash consideration was the lease and all the oil except that so reserved.*"

The language of the conveyances in the other cases heretofore cited, involving the same question, is equally broad.

[20A] Depletion has never been, and cannot be allowed to anyone whose relation to the producing property is that of a creditor. While, in a sense, a creditor may have an economic interest in the oil property which secures the obligation due him, legally he can enforce his rights otherwise than from the property. The creditor, likewise, can discharge his obligation in cash. Here, Perkins could not require Branson and Hammond to do any thing except accept their share of the oil as produced.

[21] *Paul & Mertens' Law of Federal Income Taxation*, Vol. 2, Para. 21.18, 1936 Pocket Supplement. At

rived from the extraction of oil or gas, is entitled to the depletion allowance. Thus the correct determination of the taxpayer entitled to the depletion allowance necessarily involves the prior determination of the taxpayer who must report the income.

The Government suggested in its Petition for Certiorari (p. 6) in this case that this was not true, that a different rule might be applied in awarding depletion allowances than in determining who reports income. This is a complete reversal of position, we submit. In all of the cases prior to this Court's decision in the *Palmer* case, and in that case, the Government contended that assignors, like Branson and Hammonds, were not entitled to depletion because they had parted with all of their title to the property, they did not receive income from the extraction of oil or gas, but the amounts which they received were a part of the consideration for the outright sale of the property. This was in accordance with the position which the Bureau of Internal Revenue has taken from the beginning as to the connection between income and depletion. Heretofore it has not been disputed that the "owner" of income derived from the extraction of oil or gas was entitled to a depletion allowance; the controversy has been as to whether the claimant of the allowance was such an owner. The Regulations have consistently announced

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this paragraph, pages 204 et seq. there is a splendid treatment of the whole subject, and when this is compared with the treatment in the original text, at Vol. 2, Para. 21.18, Pages 702, et seq., the development of the subject in the last two or three years is clearly shown.

this principle. In *Regulations* 45 (1918 Act) it was said, as to the statutory depletion provisions:

> "The essence of this provision of the statute is that the *owner* of mineral deposits, whether freehold or leasehold, shall, within the limitations prescribed, secure through an aggregate of annual depreciation and depletion deductions the return of" capital. (Art. 201).

And in *Regulations* 94, promulgated under the Revenue Act of 1936, the same thought is thus expressed:

> "Under these provisions of the Act the *owner* of an interest in mineral deposit, mineral properties, or timber, whether freehold or leasehold, is allowed annual depletion and depreciation deductions, etc." Art. 23(m).

It is now too late, we say, for the Government to repudiate the connection between income and depletion, particularly since the statutory provision granting the allowance has been continued in practically the same language from 1918 down through the Revenue Act of 1936.[22]

Apart from the force of this continuous interpretation, no other conclusion could be reached under the Act. The pertinent section says that:

> "In case of oil and gas the allowance for depletion shall be 27½ per centum of the gross income

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[22] In *Helvering v. Twin Bell Oil Syndicate*, 293 U. S. 312, this Court gives a comprehensive resume of all of the statutory provisions regarding depletion.

from the property during the taxable year, *excluding from such gross income an amount equal to any rents or royalties paid or incurred by the taxpayer in respect of the property.* Such allowance shall not exceed 50 per centum of the net income of the taxpayer (computed without allowance for depletion) from the property, except that in no case shall the depletion allowance be less than it would be if computed without reference to this paragraph." Sec. 114 (b) (3).

In the *Twin Bell Oil Syndicate case.* 293 U. S. 312, the taxpayer contended, in effect, that "the gross income from the property meant 100% thereof, regardless of to whom the income belonged, and that it was therefore entitled to base its allowance upon the royalties and overriding royalties going to others, as well as upon the share which it kept, this right being limited only by the phrase "50 per centum of the net income *of the taxpayer* * * * * from the property." This case arose under the 1926 Act. The statutory provision was identical with that above quoted, except that it did not contain the italicized phrase as to excluding from gross income rents or royalties paid or incurred by the taxpayer. This Court held that the italicized addition to the section, first inserted in the 1932 Law with which we are here concerned, was merely declaratory of existing practices. The taxpayer's claim was denied because the phrase "gross income from the property" was not synonomous with gross income as defined in Section 213, "property did not refer to the tract of land in all of its uses," but to "gross income from oil and gas," the "retained oil" in the case of the operator be-

ing his basis for depletion, and the royalty oil being the basis for the depletion allowance to the royalty and overriding royalty owner. Thus this Court held, we say, that the percentage depletion allowance must be based upon the taxpayer's gross income from oil and gas, not the income of some one else from that source.

So, here, if the various Circuits and the Board of Tax Appeals are correct in holding that all those similarly situated to Branson and Hammonds are entitled to percentage depletion allowances, then it was necessarily decided that they, and not those situated as Perkins is, received "gross income from oil" to the extent of the oil or its proceeds going to them.

This Court was influenced in reaching its decision in the *Twin Bell* case by the fact that, if the taxpayer's position was sound, the total allowances would be based upon more than 100 per centum of the gross income from the property because the royalty and overriding royalty owners must be awarded depletion on the amounts received by them. We have exactly that situation here. The Government has based Perkins' depletion allowance upon that oil which went to Branson and Hammonds, as well as the oil which he retained. (We did not claim this additional allowance, and admit it was incorrectly allowed). But Branson and Hammonds are entitled to an allowance upon their one-fourth, as, of course, is the ordinary royalty owner. This results, as is expressly forbidden by the *Twin Bell* decision, in aggregate allowances based upon 125 per centum of gross income from the property from oil and gas.

That each one interested in an oil property must base his allowance upon "his" gross income from the property was expressly held on March 29, 1937, by the Tenth Circuit Court in *Crews v. Commissioner*, (official citation not available). There the proceeds from oil, which had been impounded during litigation over the property, were lost through embezzlement by the custodian of the impounded fund. The successful litigant claimed that his depletion allowance should be based as well upon the amount lost by this embezzlement as upon the amount actually received and impounded as income. The Court denied this contention saying, in part:

> "It is true that the first sentence of section 114(b)(3) uses the phrase 'gross income from the property' but we think the phrase 'to the taxpayer' is necessarily implied."

This is precisely the construction for which we contend, and it is precisely the construction very recently sought by the Government in the *Crews* case,

Darby-Lynde Company v. Alexander, 51 Fed. (2d) 56, is typical of another line of cases which are pertinent here. After the percentage method of calculating depletion allowances was adopted (1926 Law), many taxpayers contended that the allowance should be based upon any gross income derived from any use or disposition of the property as, for example, an outright sale, and should not be limited to gross income derived from the extraction of oil or gas. This contention was denied, and the meaning of the phrase restricted, as this Court

later did in the *Twin Bell* case, to income derived from the extraction of oil or gas. In these cases it was not contended that depletion could be based, as to any taxpayer, upon something which was not a part of that taxpayer's gross income under Section 23. Instead, the controversy was as to how large a part of "gross income" under Section 23, could be considered as "from the property" for the purpose of fixing the depletion allowance. Similar cases are *South Vernon Oil Company v. Hopkins*, 49 Fed. (2d) 1028. *Fritz v. Commissioner*, 76 Fed. (2d) 460, affirming 29 B. T. A. 408.

We submit that all of the difficulties which the Government appears to have with tax problems, relating to oil and gas, will disappear if the Government will recognize the true nature of the developments and operations carried on under an oil and gas lease. In all of those cases, except the rare ones in which oil lands are developed and operated by a fee owner, the operation is truly a joint venture. One person has the land, but is usually without the capital or the experience, or both, necessary to realize upon it. He lets the land on shares, —sometimes receiving a cash bonus, the size of which will depend upon the brightness of the prospect of securing oil on the land, but always he shares in profits. No matter how many times this operation is repeated—by assignment, sublease, overriding royalty, oil payment or any other similar arrangement —the co-operative and joint nature of the project remains. This is true in every case, except where there is a personal fixed obligation,—a note, a debt, or some thing of that sort—given as the only consideration for

a transfer. No matter into how many portions the 100% of the oil may be divided, as long as it constitutes a common reservoir from which all parties concerned must look for a return of their capital and for their profit, so long as each one has the sole right to benefit by or dispose of a specified fraction of the oil, that one derives income from the oil as produced. He has an economic interest therein,—that is, a right to a share of the oil produced. He reports that share as a part of his gross income and, under the express wording of the Statute granting him a depletion allowance based upon this gross income from the property, he is entitled to depletion based upon the amount so accounted for as income from that property.

From this it necessarily follows that if one reports income, he is awarded depletion, and, if he is awarded depletion, it means that he has gross income from the property.

III

Certiorari was granted in this case upon the assertion that the decision below conflicted with that of the Eighth Circuit in the *Comar Oil Company* case. Apparently, such a conflict exists.

There are differences in the fact situation which will be referred to hereafter, but we will say at once that we believe it can be fairly demonstrated that the Comar decision is unsound; that it is based upon a misconception of well established Departmental tax practices, upon a misconstruction of the Statutes involved

and a misapplication of the authorities cited to support the conclusion reached.

Although *Palmer v. Bender*, supra, by this Court, was cited in the opinion, its significance was not, we respectfully say, appreciated. In their briefs both parties refer to the Circuit Court's decision in the *Palmer* case, but all briefs, except that contained in the Petitioner's Motion for Rehearing, were prepared before this Court's decision in the *Palmer* case, and that decision was no where discussed by either party.

The facts hereinafter pointed out are based more upon an examination of the Record in the Eighth Circuit, than upon statements in the opinion. There were three different transactions involved. One was with Goldelline Oil Corporation, one with Henry Rosenthal and one with Alcorn Oil Company. That with Goldelline Oil Corporation comes nearer paralleling the one here involved than the others, and it will be first referred to.

The assignment made to Comar Oil Company by the aforesaid corporation recited a consideration of $50,000.00 "and the additional sum of $100,000.00 net to be paid out of the oil and gas as hereinafter set out." It purported to assign all of the assignor's right, title and interest. It was further provided:

> "The above mentioned sum of $100,000.00 net shall be paid to the assignors herein out of one-eighth of the gross production of oil and gas produced from said property, by the assignee or its assigns, and said assignors shall not be liable, and their one-eighth of the oil and gas shall not be

chargeable with any cost and expense of developing, operating and marketing said oil and gas or any cost whatsoever. Statements of production and payments thereunder shall be made by assignee each month to Goldelline Oil Corporation and Errett R. Newby until each shall have received the sum of $50,000.00 out of the said one-eighth of the gross production. It is understood that a lien is hereby retained by first parties on said one-eighth of the oil and gas until said sum of $100,000.00 is paid."

Thus this instrument did not expressly negative personal liability upon the part of Comar Oil Company for the additional $100,000.00. It was not provided that said sum should be paid "only" out of oil. The quoted excerpt, with other testimony, show clearly that Comar did not deliver oil in kind, but sold all of the oil and accounted for proceeds. The inference that a creditor-debtor relation existed was re-enforced by the provision for a lien.[23] The obligation which would usually be implied in such an instrument to develop reasonably, or to stand the consequences, was not negatived. This, we say, is the instrument which more closely parallels the assignment to Perkins than any other involved (R. 44 Comar case).

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[23] The Board of Tax Appeals, in the *Fleming* case, 31 B. T. A. 623, considered the *Comar* case and distinguished it in the following language (Page 627): "There it appears that the assignee and his assigns were liable for the deferred payment, and the assignor had a lien on one-eighth of the oil produced from the property until the amount of the deferred consideration was paid."

The Rosenthal assignment contained no provision whatsoever for an oil payment. It recited a consideration of One Dollar and other good and valuable considerations, and purported to assign all rights to the lease and to warrant the same (R. 50 Comar Case). The provision for the oil payment was contained in the preliminary contract of purchase, and nothing in the Record indicates that it ever went of record or otherwise qualified the apparently absolute title acquired by Comar. This contract provides:

> "That the first party hereto has this day bargained, sold and assigned and transferred to second party hereto all of his interest in the said oil and gas lease upon said lands hereinabove described, same being an undivided one-fourth interest, for the consideration of One Hundred Thousand Dollars cash, and Fifty Thousand Dollars to be paid to the party of the first part by party of the second part out of one-half of their portion of the first oil or gas produced, same to be made when and as the oil is sold." (R. 49 Comar Case).

The same situation existed as to the largest transaction,—that with the Alcorn Oil Company. The provision regarding payment, was contained in the preliminary purchase contract (R. 54 Comar Case), and not in the assignment placed of record (R. 57, Comar Case), which assignment merely recited one dollar consideration paid, and conveyed with a warranty of title all of the Alcorn Oil Company's interest in the lease.

The purchase contract referred to bound the Comar

to pay Three Million ($3,000,000.00) Dollars; $1,750,000.00 upon approval of title:

> "• • • the balance, amounting to One Million Two Hundred Fifty Thousand Dollars ($1,250,000.00) shall be paid by Comar out of fifty per cent (50%) of the oil produced as represented by the working interest in said properties. The title to all of the working interest in the oil produced from said properties subsequent to the date of this agreement shall be in Comar Oil Company, and as oil is produced Comar Oil Company shall pay to the Alcorn Oil Company sums of money equivalent to the value of fifty per cent (50%) of the oil produced, as aforesaid."

Under all of these instruments, no oil was delivered in kind, or intended to be, and the last instrument expressly provided that title to all oil passed to the Comar Oil Company the assignor to be paid amounts "equivalent" to the value of fifty per cent (50%) of the oil produced.

When the case reached the Circuit Court, that Court, in its consideration of the matter, divided the question into two parts. The first was whether it was proper to include the payments made to the three assignors in the income of Comar. The second was whether, if they were so included, they should not have been thereafter eliminated as allowable deductions.

In dealing with the first branch of the question, the Court first referred to the broad scope of the general definition of "gross income" in the Act and said, citing authorities, that this definition was broad enough

to include, in the case of a lessor, rents or royalties paid to him by the lessee. This, of course, is a sound statement, but the Court continued:

> "• • • broad enough to include, in the case of a lessee, rents or royalties *paid by him to the lessor owner;* and the practice has been to include them as gross income in the return."

If we may be permitted to assume that the Court meant exactly what it said in this quotation, then we say that there is disclosed a complete misconception of the situation. We say that rents paid by a lessee are not included by the lessee, who pays them, as a part of his gross income, and cannot be. The same is true of royalties paid by a lessee. If the Circuit Court's statement were correct, the more rent or the larger royalty a lessee paid, the more would be his gross income.

The cases cited by the Court to support this statement utterly fail to do so. Not one hints at such a conclusion. They are all briefly analyzed and discussed in the Appendix, infra page 71.

If what the Court intended to say was that the lessee's or tenant's receipts from which, in the ordinary case, he might expect to pay rents or out of which he would defray royalties constitute a part of his gross income, another situation is presented. Such a statement may or may not be accurate, depending upon the precise facts.[24]

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[24] Rents or royalties payable in cash need not be paid out of the gross income of the one making the payment. Of course the one obligated expects to derive

The Court then referred to the fact that the payments in question were called "overriding royalties" and that Comar contended that these overriding royalties should be treated in the same manner as the original royalties. The Court thought that this contention was sound:

> "• • • in so far as it results in the inclusion of both the original royalties and the overriding royalties in the catagory of 'gross income'."

The Court recognized the forcefulness of the argument that neither overriding royalties nor original royalties should be included in the gross income of a lessee, sublessee or transferee, but said that the argument should be addressed to Congress, because the inclusion of them in the gross income of the lessee found support in the definition of gross income in the Act and "in the actual practice established during a considerable number of years. See cases cited above." These cases cited are those which we have discussed in the Appendix. Thus it will be seen that the Court predicated this part

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gross income from his business operations sufficient to discharge his rents and royalties and yield a profit, but as a matter of fact they may be paid out of capital, out of borrowed money, out of the sale of assets which produced no profit or resulted in a loss, out of inherited or donated funds, or from many other sources. The recipient is ordinarily not concerned with the source of the money. If the royalties are payable in kind, as oil royalties customarily are, they do not, under the long established practice as shown by the Record in this case and under well settled principles, constitute a part of the lessee's gross income.

of its opinion upon the entirely mistaken hypothesis that in the case of original royalties the lessee was required to report these royalties as a part of his gross income. The cases cited by the Court to sustain its statement do not do so. The Government cannot point to any other cases which do so. We established the departmental practice by uncontradicted evidence and that practice is this: Royalties payable in kind are not included in the gross income of the lessee or operator. Where royalties are payable in cash, the lessee reports the proceeds from the sale of all minerals and takes an offsetting deduction for the royalties paid. The propriety of such a deduction was admitted in the brief below. There it was argued that the amount received by Branson and Hammonds constituted payment of a portion of the purchase price and it was said, on page 18 Collector's brief below.

> "There is no similarity between such a payment and that of an original royalty or rent, fixed in amount and time, which of course may be deducted as an expense."

Having concluded, by the line of reasoning above analyzed, that Comar was required to include the proceeds from the sale of all of the minerals as a part of its gross income, the Court next turned to whether or not Comar could deduct from this gross income the amounts paid over to its several assignors. Upon this point the Court said:

> "We think the statute makes plain distinction between rentals or other payments for the con-

tinued use or possession of property to which the taxpayer has not taken title or in which it has no equity on the one hand, and rentals or other payments for the continued use or possession of property to which the taxpayer has taken title or in which it has an equity on the other hand. The former rentals are deductible; the latter are not. What the reason for the distinction is, we are not called upon to decide."

It should be noticed that the Court had previously held that the payments in question were overriding royalties which should be treated as ordinary royalties. It was not decided, as the Government here contends, that these were payments to apply upon the purchase price. The quoted conclusion reached by the Eighth Circuit directly conflicts with the admission made in the brief below by the Government, which we have previously quoted. It conflicts with long-established practice upon the part of the Bureau of Internal Revenue, for all royalties and rents (except those payable in kind which are never dealt with at all in the payer's tax return) have always been deductible. The language of the Statute (set out in full below)[25] refers to an

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[25] *Revenue Act of* 1932. "Sec. 23. Deductions From Gross Income. In computing net income there shall be allowed as deductions: (a) Expenses.—All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business . . . . and rentals or other payments required to be made as a condition to the continued use or possession, for the purposes of the trade or business, of property to which the taxpayer has not taken or is not taking title or in which he has no equity."

entirely different type of transaction than those relating to mineral properties involved here. Those here involved were not made for the "continued use or possession of property to which the taxpayer has not taken title or in which it has no equity." In many States a lessee or his assigns cannot take title to oil in the ground. The general rule is that non-payment of royalties under an oil and gas lease does not work a forfeiture of the lease.[26] Use and possession for the purpose of prospecting for and producing the oil, or other minerals, are acquired for the down consideration or bonus (which the lessee paying same capitalizes and does not deduct),[27] and the royalties, payable in kind or measured by the quantities produced, represent the lessor's share of the profit from the mining operation which he realizes through the ancient device of leasing on a royalty basis.

It is interesting to note that upon this phase of its

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[26] *Thornton on "Oil and Gas"*, 5th Ed. (Willis), Vol. 2, p. 562, paragraph 304, and authorities there cited. Under these decisions the payment of the royalties is not a condition to the lessee, or any one holding under him, continuing to use or possess the property. If it were such a condition, a breach of the condition would work a forfeiture. This phase of oil and gas law, at least in so far as it applies to Texas, is fully discussed in *Waggoner Estate v. Sigler Oil Company*, 118 Tex. 517, 19 S. W. (2d) 27.

[27] This has always been the rule. The bonus, as to the lessee, is his cost, recoverable through depletion, when depletion is taken on the basis of cost. See *Art.* 203, *Regulations* 45, 1918, Act, and this has been carried through continuously to the present time. *Art.* 23 (m-6) *Regulations* 94, 1936 Act.

opinion, the Eighth Circuit cited no decisions whatsoever.

It was after that portion of the opinion which we last quoted that the Eighth Circuit referred to the *Palmer* case by this Court. It then said, after saying that they were not called upon to decide the reason for the distinction:

> "It may be that the Congress thought that in the latter class of cases, the depletion allowance provided in section 234(a) (9) could be made and would be sufficient. See Palmer v. Bender, 287 U. S. 551. Whatever the reason for it, the distinction, we think, exists."

Thus that Court indicated that the lessee or operator would be compensated for a refusal to allow it to deduct royalties paid by an allowance for depletion with respect to the oil applicable to the oil payments. But, under the *Palmer* case, under the *Fleming* case, and similar cases, that allowance would go to the assignor-oil payment holder, and, under this Court's decision in the *Twin Bell Oil Syndicate* case, the same amount could not be made the basis for the same or a corresponding allowance to the lessee operator. Indeed, as this Court pointed out in the *Twin Bell* case, the Statute with which we are here concerned expressly required all royalty payments made by a lessee to be deducted from gross income before computing percentage depletion, and this, as this Court pointed out, was not new; it was merely declaratory of long existing practices.

There is nothing in the *Comar* case which tends to

support the theory upon which the Government sought below, and here seeks, to sustain its position. That theory, and the one adopted by the Trial Court, was that the assignment conveyed title to all of the oil which formerly belonged to the assignor or lessee, and that the oil and money which went to Hammonds and Branson were payments upon the purchase price of this oil. We fail to see how the Government can find comfort or obtain support for any such theory by any thing said or inferred in the *Comar* decision. And, as above shown, the principles upon which that Court founded its decision are contrary to the Government's long continued practices, and some of the statements there made have been expressly repudiated by the Government in its argument below.

IV

The opinion of the Fifth Circuit in *Palmer v. Bender* was typical of a group of opinions delivered by that Circuit, within the space of a few years, in which the same principles were applied. Many of these cases involved the identical contracts which were involved in the *Palmer* case.

A typical case involving a different contract is *Pugh v. Commissioner*, 49 Fed. (2d) 76. As stated by the Fifth Circuit in the case at bar, the Trial Court appeared to prefer the reasoning of this opinion to the opinion delivered by the same Court in the *Fleming* case, *supra*. An analysis of that case will show that it was necessarily overruled by this Court's decision in the *Palmer* case. Pugh was a landowner who had leased his

lands, retaining the usual royalty. He later transferred this royalty. The assignment purported to transfer all of it, but the consideration expressed was partly cash, with the remainder from a specified percentage of the oil to be produced from the property. Pugh claimed depletion with respect to the amount received from the oil produced after his transfer. The Fifth Circuit held that this was a conveyance, as well of the amount of the oil necessary to satisfy the oil payment as of the remainder of the estate conveyed, and, because of that, denied the claim for depletion. Similar results were reached by the same Court, not only by its decision in the *Palmer* case, but in *Waller v. Commissioner*, 40 Fed. (2d) 892; *Herold v. Commissioner*, 42 Fed. (2d) 942; *Beene v. Commissioner*, 40 Fed. (2d) 892; *Baird v. Commissioner*, 65 Fed. (2d) 911.

It would appear that the Fifth Circuit expressly recognized the fact that this Court's decision in *Palmer v. Bender* overruled the Fifth Circuit's decision in the *Pugh* and similar cases, for it was there said:

> "We have thus looked at the transaction broadly, as was done in *Palmer v. Bender*, and not technically, as was done in the *Pugh* case."

And this recognition is made clearer by the opinion in the present case. The Court below said (R. 98):

> "In dealing with income taxes in connection with transactions in oil leases this court at first attempted to apply the peculiar law of Texas or Louisiana and the resulting technical relationships of the parties. Such decisions were made in Pugh

> v. Commissioner, 49 Fed. (2d) 76; Harmel v. Commissioner, 56 Fed. (2d) 153; and Palmer v. Bender, 57 Fed. (2d) 33. • • • • While the reasoning of the Pugh case may be correct upon a question of title to the oil and the ordinary consequences of title, we cannot regard it as a valid authority on the present question."

The Ninth Circuit, in *Commissioner v. Elliott Petroleum Company*, 82 Fed. (2d) 193, a case similar to the *Fleming* case, said:

> "Our conclusion is in accord with the decision of the Tenth Circuit Court of Appeals in Alexander v. Continental Petroleum Co., 63 Fed. (2d) 927, under the Revenue Act of 1926 and the above cited decisions of the Supreme Court. The case of Pugh v. Commissioner, 49 Fed. (2d) 76, cited by the Commissioner, it is agreed tends to support his contentions, but in so far as it conflicts with Palmer v. Bender, 287 U. S. 551, supra, it is no longer authority."

In the *C. C. H.* 1936 *Tax Service*, Volume 1, paragraph 204.143, page 834, there are listed a large number of decisions which are stated to be "no longer effective as precedents due to the holding of the Supreme Court in the *Palmer v. Bender* case." And *Paul and Mertens* in their *Law of Federal Income Taxation* say that these cases "have now in principle been reversed by a recent decision of the Supreme Court." See Paragraph 21.18, Volume 2, page 702. Both of these authorities cite all of the cases above listed.

We believe the Government must base its position here upon exactly the contention which it made in all

of these cases which we have referred to. That contention is that under the terms of the assignments involved the assignor parted with all his title to the oil and placed all of the title in the assignee, so that the assignee, situated as Perkins is here, should report the proceeds from the sale of the oil as his income, and so that he would be entitled to depletion with respect to all of it. This basic position which the Government must take has been expressly recognized by many authorities to have been overruled by this Court in *Palmer v. Bender*.

V

The following principles, though unrelated, are pertinent and require, we submit, an affirmance of the lower Court's decision.

(a) The Bureau of Internal Revenue would have accorded the tax treatment desired by Perkins, if the instrument had "reserved" one-fourth of the oil to Branson and Hammonds until they had received the specified sum; but contends that the treatment should be different because the assignment to Perkins assigned the entire lease (as was done in the *Palmer* and *Fleming* cases) and bound Perkins to pay or deliver one-fourth of the oil until the same sum was received. But there is not the slightest practical difference in the two situations. Perkins' gain under one is exactly what it would have been under the other. Such immaterial differences in phraseology should not be made the basis for very substantial differences in tax liability. We challenge the Government to point out any practical dif-

ference under the two types of instruments.[28]

(b) While the Bureau of Internal Revenue contends that the oil payment going to Branson and Hammonds is a part of the consideration paid by Perkins, it has refused to follow this principle to its logical conclusion in this case, and many others. If Branson and Hammonds conveyed all of their interest in the leases to Perkins in consideration of cash and an additional sum to be paid later, it would seem that this additional sum, even though contingent, would necessarily be a part of Perkins' original cost, in just the same way as if he had given notes for a deferred consideration. There might be a difference in the value of notes unconditionally enforceable and the value of an obligation contingently payable, but each, on some basis of value, would represent, under the Government's theory, a part of the original cost, and to be consistent the Government should treat this additional sum as a part of the cost, just as it would deferred payments. If this were done, Perkins would be allowed to base his cost depletion deduction upon this total cost, just as in the case of property bought on credit depletion or depreciation on cost would be based upon the purchase price, regardless of when paid.

Instead of following this theory, the Government treats as the basic cost, for cost depletion purposes, the

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[28] We have ventured to insert in the Appendix page 85 excerpts from an actual case now pending to illustrate the distinction which the Bureau of Internal Revenue is making at the present time because of the verbiage of the instrument.

consideration actually paid in money or notes at the date of the conveyance. To this, each year, is added the amount actually received by the oil payment holder, and thus for the next year the cost depletion basis is the original basis, plus this additional payment, so-called, and this process is repeated each year until the oil payment is extinguished. Thus as the property is depleted and as oil reserves go down, the taxpayer's cost for depletion purposes, under this theory of the Government, goes up, increasing each year the depletion unit. But the logical result of production and extraction is to retire cost and to reduce depletion charges ratably. Let us illustrate this result, using an extreme but not impossible case for the sake of brevity.

Assume an assignment for $10,000.00 in cash and $90,000.00 payable out of 6/8ths of the oil (1/8th, as in the customary case, going to the landowner as royalty and the other 1/8th being "free" for the operator). Assume a 200,000 barrel reserve and a price of oil of $1.00. During the first year the operators produces 100,000 barrels and completely retires the oil payment. During that year his cost is $10,000.00, his reserves 200,000 barrels and his depletion allowance five cents per barrel. The next year his cost would be $10,000.00, plus the amount of the oil payment—$90,000.00, less the $5,000.00 depletion allowed in the previous year; his reserves would be only 100,000 barrels and his depletion unit, ninety-five cents per barrel.

It should also be recognized that in this case if production should suddenly terminate early in the second

year, the operator under the Government's theory would have a loss deduction of $95,000.00.

These entirely fanciful and impractical results arise from the falure of the Bureau of Internal Revenue to recognize the practical fact that the operator in such a case did not acquire all of the oil—that, instead, he was merely producing on shares.

(c) We desire to emphasize that the testimony in this case shows it to be the established practice of Oil Purchasing Companies, (and indeed Courts would probably take judicial notice of the fact without such testimony), to require the execution of division orders, like those shown in the record in this case, by all interested in an oil well before the oil purchaser will run and pay for the oil. The division orders in this case show that Branson and Hammonds on the one hand, and Perkins on the other, recognized that they jointly owned the working interest; that Branson and Hammonds had one-fourth thereof and Perkins three-fourths. They refer to themselves in such division orders as the "owners" of these respective fractions. The Purchasing Companies so recognized and treated them. No Purchasing Company would have paid Perkins for Branson and Hammonds' one-fourth of the oil. All of these facts and customs must be read into the assignment from Branson and Hammonds to Perkins, for they certainly contracted in the light of established trade practices and customs. These customs should be considered in connection with the language of the instrument to the effect that the oil was to be delivered by Perkins to Pipe Line Companies for the account of Branson and Hammonds, who were

to be paid directly for the same by the Pipe Line Companies.

These facts not only show the practical aspects of the situation; but they show convincingly the way the parties interpreted their own contract.

VI

The Trial Court appeared to be concerned over the economic consequences of a holding to the effect that Perkins should not include as a part of his income the proceeds from the oil going to Branson and Hammonds (R. 19), and the Government's Petition for Certiorari in this case suggests that it shares in such concern. It is clear, however, that there is no actual basis for such concern; rather, we say, the oil industry should be concerned over the present attempt to impose double taxation upon it.

The Trial Court spoke of the enormous amount of money which would "be swept aside as income" if the contention advanced by Perkins should be upheld. This is a mistaken conception. As we have heretofore pointed out, all of the money or income produced from an oil well will be taxed as gross income to those actually benefited thereby if our theory of the case is upheld. The royalty owner will report his share; Branson and Hammonds will report their share and Perkins will report his share. But we will admit that neither of these parties will be taxed but once upon the same income, while, if the Government's theory is adopted, two people will be simultaneously taxed upon the same income.

Take this very case as an example. We may safely

infer from the date of the original leases and because none of them had been developed by Branson and Hammonds at the date of their transfer to Perkins, that Branson and Hammonds' investment in the leases was very much less than the $155,000.00 received in cash and notes from Perkins, and this much of the transaction with Perkins resulted in a substantial profit to them. This profit should have been, and no doubt was taxed to them,—that is the difference between their cost and $155,000.00. Now, if the additional amounts which they receive are taxed to them as a part of the consideration, they will report as income one-fourth of the amount produced by the oil wells in question, although this one-fourth is simultaneously included as a part of Perkins' gross income. This, clearly, is double taxation.

To this the Government may say that the same result would be reached if Perkins had given an unconditional obligation of $395,000.00, but had actually retired this obligation out of the proceeds from the sale of one-fourth of the oil. But this is not correct. In such a case, this $395,000.00 would have been treated by the Government as cost and Perkins would have immediately been permitted to deduct cost depletion based on that amount. Under the Government's practice this right is denied him and the depletion deduction deferred to be realized, if at all, long after he has been compelled to combine that which is actually the income of Branson and Hammonds with his own income and pay taxes upon the total at progressive rates, thus burdening him, not only with taxes upon some one else's income, but with higher rates upon his own income.

We respectfully say that the economic consequences which might result if the Government is permitted so to tax business interests is to ruin and destroy those interests. The Government should be satisfied to tax income only once. With rates as high as they are now, it is entirely possible for an oil producer, operating under a plan like that here involved, to be taxed at more than 100% of what he is permitted to keep "for his separate use, benefit and enjoyment."

VII

The Government's brief in this case was only received shortly before Respondents' brief was completed. In concluding we will refer directly to some of the arguments there advanced.

In the opening sentence of the Petitioner's Summary of Argument it is said "Taxpayer and associates operated oil wells and sold the oil." Under this Record we say it is clear that Respondent did not sell the one-fourth of the oil going to Branson and Hammonds. They could not sell the same under the terms of their assignment and under clearly established and well-known trade practices and customs, and they made no attempt to do so. Instead, they delivered one-fourth of the oil into the Pipe lines serving the property to the credit of Branson and Hammonds and Branson and Hammonds executed each and every instrument by which the oil was sold and collected directly therefor in accordance with the terms of these instruments from the purchasers of the oil.

Petitioner next says: "The proceeds of all of the

sales of oil made by them constituted income from their business." This is incorrect, we say, because so much of the proceeds as went to Branson and Hammonds were never, and never could have been, received by Respondents for their own benefit, or for their separate use and disposal. If they had appropriated this oil, they could have been held for conversion, in just the same way as if they had appropriated the royalty owner's one-eighth.

The Petitioner then proceeds to assert that Perkins acquired complete title to the lease and to the oil in place. We have already replied sufficiently to this, except in so far as the Petitioner predicates its assertion upon the case of *Holliday v. Erwin*, 85 S. W. (2d) 355. This is a decision by one of eleven Courts of Civil Appeals of Texas,—intermediate courts. That Court attempted to make a distinction because the assignment provided for a payment "out of 1/4th of the 7/8ths of the first oil," instead of a provision that the assignor was to "receive 7/8ths of the first oil produced," and because it did not contain an express provision that title was to remain in Erwin until he was paid.

Apart from this, an examination of the entire opinion, including the opinion delivered on Motion for Rehearing, will show that the Court's decision was predicated, primarily, upon whether or not the particular action, which was to cancel a receipt given acknowledging satisfaction of the oil payment, could be maintained on non-resident service.

Most important, in connection with this case, is the fact that on October 9, 1935, the Supreme Court of

Texas granted a writ of error in this case. The notation made by the Court in granting this writ of error was in the following language:

> "Granted on first assignment."

This assignment was that:

> "The Court of Civil Appeals erred in holding that, under the terms of the assignment from appellee of the oil and gas lease, he conveyed all his rights in the lease and thereby, in effect, holding that appellee, under the facts pleaded and proven, did not show himself to have any interest in the land and, therefore, his action was not one to establish such an interest." See The Texas Syllabi, Vol. 12, No. 2, issued under date of October 9, 1935.

At the date this brief is written, this case had not been submitted to the Supreme Court of Texas, and will probably not be heard by that Court before late in 1937. We say that it is much too early for the Petitioner to assume that the Supreme Court of Texas will qualify, in *Holliday v. Erwin*, supra, the long considered doctrine which it announced in *Sheffield v. Hogg*, supra.

The Petitioner then says, in his Summary of Argument:

> "Since the capital and labor entering into the production of the income here in question was owned and furnished entirely by the taxpayers, etc."

The Fifth Circuit, in construing a very similar in-

strument, reached exactly the opposite conclusion. In the *Fleming* case, supra, that Court said:

> "Contrariwise, the payments from oil were not the independent capital of the purchaser, but represented a part of the oil reserved."

The concluding sentence in the Summary of Argument is: "The taxpayers recover back their capital outlay through an allowance for depletion." This would seem to be an admission that the amounts received by Branson and Hammonds were not royalties or rentals. If they were, then under the Statute, even if we assume that the proceeds from all of the oil should have been reported by Perkins, his depletion allowance could not be based upon these rents and royalties because of the provisions in *Section* 114(b)(3) of the Revenue Act of 1932, excluding from gross income before computing percentage depletion:

> "An amount equal to any rents or royalties paid or incurred by the taxpayer in respect of the property."

This has been heretofore discussed, but we point out again that if these payments were a part of the purchase price of the leases, then all of the Courts who have granted depletion allowances to those similarly situated to Branson and Hammonds have done so in direct conflict with the well established rule that no depletion is allowable to the seller of an oil property with respect to the consideration received by him from the sale of the property.

Petitioner cites *Poe v. Seaborn*, 282 U. S. 101, one of the Community Property Tax Cases, in support of his assertion that the answer to the question of ownership must be found in the law of the State. We believe that this standard is very favorable to Respondent's view, and that the question of ownership under State law has been settled by *Sheffield v. Hogg*, supra, but in view of *Lynch v. Alworth Stephens Company; Palmer v. Bender* and *Burnet v. Harmel*, all by this Court, we seriously question whether the State law furnishes a complete answer to the question; but we submit, as heretofore pointed out, that any test which can properly be adopted will result in sustaining Respondents' position.

The Petitioner says:

> "If we find that under State law a particular taxpayer owns the capital which enters into the production of particular income and also performs the labor entailed in its production, it follows that that taxpayer is taxable under the Federal revenue laws upon that income."

And, after quoting from *Stratton's Independence v. Howbert*, 231 U. S. 399, it is said:

> "It would seem to follow that those who conduct that business (mining) are the ones to be taxed with its profits."

We ask the Petitioner to apply this theory to the ordinary royalty owner. If he says that under State law the ordinary royalty owner owns a share of the capital, then we ask him to point out why the lessee

upon assignment, by using language similar to that contained in the original lease, upon which the lessor's rights are predicated, cannot also continue to own a share of the capital—the oil in the ground? We do not believe that the one who conducts a business is necessarily to be taxed with all of its profits. We had always thought that the ancient landlord and tenant relation, particularly where land is let for a share of the crop, was a well known example of one conducting a business without being taxed upon all of the profits which resulted therefrom.

We will not extend this argument by discussing those decisions of Texas Intermediate Appellate Courts decided prior to *Sheffield v. Hogg*, which are cited by Petitioner. Whatever might have been said in them (and everything has been said in every way, as any one who examines all of the available decisions will find) is immaterial in view of the later and controlling opinion by the highest State Court.

The Petitioner refers to *Group No. 1 Oil Company v. Bass*, 283 U. S. 279, and to the fact that this Court in that case cited *Theisen v. Robertson*, 117 Tex. 489. An examination of *Sheffield v. Hogg*, supra, will show that the Supreme Court of Texas has repudiated the doctrine that the lessee acquired all of the oil and gas.

It should be noted that the Petitioner makes no serious attempt to sustain the reasoning in the *Comar Oil Company* case, upon which he predicated his Petition for Certiorari in this case. He avoids the depletion question and disregards the necessary connection

between income and depletion. He assumes that rents and royalties, in so far as they refer to an ordinary oil and gas lease, are paid for the continued use, possession or enjoyment of property in which the taxpayer paying them has an equity and are, therefore, not deductible; although, since we have had income taxation the Bureau of Internal Revenue has recognized—first, that royalties payable in kind are not to be accounted for in the gross income of a lessee; and, second, if they are payable in cash, they constitute a deductible allowance from the income of the lessee for the year with respect to which they are paid.

We submit that the issues would be clarified and the solution of the important tax problem now before the Court made easier if the Petitioner would frankly deal with the well settled practices of the Bureau of Internal Revenue in regard to the taxation of ordinary royalties, and if he would recognize the necessary relation between our present problem and the closely related problem of depletion.

We say that it is clear that Perkins derived no income on account of the one-fourth of the oil going to Branson and Hammonds, and that, not only is this controlling, but, unless the Petitioner can deny:

(a) That Branson and Hammonds are entitled to depletion upon the amounts received by them to apply on the oil payment;

(b) That if the said amounts were received as a part of the consideration for the sale of property, Bran-

son and Hammonds would not be entitled to depletion thereon;

(c) That if the Trial Court was correct in holding that Perkins bought all of the interest of Branson and Hammonds in the property, the proceeds from the sale of the oil subsequently produced was the gross income of Perkins "from the property" so that his depletion allowance must be based upon all of the same;

(d) That percentage depletion cannot be based upon more than 100% of the gross income from the property;

(e) That the amounts going to Branson and Hammonds cannot at the same time be "rents and royalties" and consideration received by them for the sale of the property;

The Petitioner should not prevail in this Court.

Respectfully submitted,

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APPENDIX A

TAXING STATUTES INVOLVED.
THE REVENUE ACT OF 1932

"SEC. 21. NET INCOME.

"'Net income' means the gross income computed under section 22, less the deductions allowed by section 23.

"SEC. 22. GROSS INCOME.

"(a) GENERAL DEFINITION.—'Gross income' includes gains, profits, and income derived from salaries, wages, or compensation for personal service, of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. • • • •

"SEC. 23. DEDUCTIONS FROM GROSS INCOME.

"In computing net income there shall be allowed as deductions:

"(a) EXPENSES.—All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including a reasonable allowance for salaries or other compensation for personal services actually rendered; traveling expenses (including the entire amount expend-

ed for meals and lodging) while away from home in the pursuit of trade or business; and rentals or other payments required to be made as a condition to the continued use or possession, for purposes of the trade or business, of property to which the taxpayer has not taken or is not taking title or in which he has no equity.

• • • •

"(1) DEPLETION.—In the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case; such reasonable allowance in all cases to be made under rules and regulations to be prescribed by the Commissioner, with the approval of the Secretary. In any case in which it is ascertained as a result of operations or of development work that the recoverable units are greater or less than the prior estimate thereof, then such prior estimate (but not the basis for depletion) shall be revised and the allowance under this subsection for subsequent taxable years shall be based upon such revised estimate. In the case of leases the deductions shall be equitably apportioned between the lessor and lessee. In the case of property held by one person for life with remainder to another person, the deduction shall be computed as if the life tenant were the absolute owner of the property and shall be allowed to the life tenant. In the case of property held in trust the allowable deduction shall be apportioned between the income beneficiaries and the trustee in accordance with the pertinent provisions of the instrument creating the trust, or, in the absence of such provisions, on the basis of the trust income allocable to each. (For

percentage depletion, see section 114(b) (3) and (4).)"

"SEC. 114. BASIS FOR DEPRECIATION AND DEPLETION. * * * * *

"(b) BASIS FOR DEPLETION.— * * *

"(3) PERCENTAGE DEPLETION FOR OIL AND GAS WELLS.—In the case of oil and gas wells the allowance for depletion shall be 27½ per centum of the gross income from the property during the taxable year, excluding from such gross income an amount equal to any rents or royalties paid or incurred by the taxpayer in respect of the property. Such allowance shall not exceed 50 per centum of the net income of the taxpayer (computed without allowance for depletion) from the property, except that in no case shall the depletion allowance be less than it would be if computed without reference to this paragraph."

APPENDIX B

Analysis of the cases cited by the Eighth Circuit Court in the Comar Oil Company case to support the assertion made in the opinion in that case that rents and royalties paid by the lessee should be included in the gross income of the lessee paying the royalties or rents and that the practice had been to include the rents and royalties so paid in the gross income of the lessee.

United States v. Boston and Providence Railroad Corporation, 37 Fed. (2d) 670, First C. C. A., decided January 23, 1930:

The basic question involved in this case was a determination of the invested capital of the railroad corporation in order that its excess profits tax for the year 1918 could be properly determined. This company was a lessor and not a lessee. Before 1890 it had executed a ninety-nine year lease on its railroad properties for a cash payment of $1,300,000.00, annual payments of $400,000.00, a sum sufficient to keep the corporate organization alive, and certain covenants as to maintaining the property, paying taxes, etc. In addition thereto, the lessee had covenanted to pay off at maturity the funded and floating debt of the lessor railroad corporation and to create a sinking fund for the purpose.

The determination of invested capital turned upon the question of whether or not any part of the value of this contract to pay the debt of the lessor and to

establish a sinking fund for that purpose could be included in the invested capital of the lessor under the Revenue Act of 1918.

The railroad company of course contended that it could be. The First Circuit Court seemed to think that the question should be answered by determining whether or not, if the taxing statute had been in force when the lease was made, all or any portion of the value of this contractual obligation would have been treated as taxable income to the lessor. The Court said:

> "An amount paid in advance as rental, or as a bonus for a leasehold interest, may be prorated by the lessee in computing his income tax over the period of the term, upon the ground that the interest acquired is an exhaustible capital asset • • • or is a part of the rental; but, as to the lessor, in computing his tax it is treated as income in the year in which it is received. • • • While the case is not entirely free from doubt, we think the obligation to discharge the funded debt of the petitioner in this case was properly treated by the court below as income received when the lease was signed, at least to an amount equal to the fair cash value of the obligation."

Here, of course, the Court was dealing with the lessor. The lease did not involve a wasting asset like oil in the ground, and the Court expressly recognized that even such a lump sum payment as it was considering could be deducted over the life of the lease. If such a situation can be compared with a transaction relating to oil and gas, it is much more comparable to the bonus

or advance royalty paid by a lessee upon the execution of a lease. As to such a payment, the long established custom has been to treat the amount received as income to the lessor, subject to depletion, and as cost of the leasehold to the lessee who paid the bonus, but recoverable through amortization or other deduction over the life of the lease. In the case at bar we are concerned of course with payments comparable to the ordinary royalties paid under an oil and gas lease, which, as frequently stated in other portions of this brief, if payable in kind, never are included in the gross income of the lessee; and if payable in cash, are always deductible by the taxpayer.

The second case cited is *International Textbook Company v. United States*, 44 Fed. (2d) 254, decided by the Court of Claims on November 3, 1930. In that case one of the affiliated corporations which formed the group of corporations which were plaintiffs has acquired, in consideration of an advance of money and an agreement to pay a percentage of the gross receipts derived from selling the books, the exclusive right to sell certain domestic science courses. The tax year involved was 1918. The taxpayer sought to deduct in 1918 a portion of the cash payment made in 1916 when the contract above referred to was entered into. The Court of Claims denied this contention, pointing out that this cash payment was in no way dependent upon the amount the taxpayer was to receive from the sale of the course and that:

> "The whole amount was a fixed obligation from the time the contract was signed. It was an

obligation arising at the time the contract was made and was a payment for property rights of an income-producing nature available to the plaintiff from that time forward as long as the courses were desired."

In response to the argument that the taxpayer was entitled to a deduction for the exhaustion of these contract rights, it was pointed out that the rights were of an indefinite duration and there was no basis for a computation of exhaustion under the statute.

So this case merely holds that if one acquire for a down payment the exclusive rights, unlimited as to time, to market a literary product, the amount of the down payment can not be deducted from income in a later year and no part of it is deductible because of exhaustion of the rights, for the reason that the rights are of an indefinite duration and there is no basis for computing the exhaustion.

If we were to compare the situation to an oil and gas transaction, it might be considered the equivalent of a transfer for a cash consideration of the exclusive right to mine and appropriate for an indefinite term, rather than the limited term ordinarily fixed, all of the oil or gas under a specified tract. Such a payment would be treated as cost to the one acquiring these rights and would be recoverable through depletion if oil was discovered, because the reserves could then be estimated and a basis for the computation established, but until oil was discovered there would be no basis for amortization on account of the lapse of time and the

using up on that account of a portion of the rights granted.

We submit that this case throws no light whatever upon the correct treatment by a lessee of royalties paid in cash or kind as minerals are produced or any other such current payment.

The third case cited is *Baton Coal Company v. Commissioner of Internal Revenue*, 51 Fed. (2d) 469, by the Third Circuit Court of Appeals, decided July 28, 1931, under the Revenue Act of 1926. The taxpayer there had entered into a lease on coal lands to extend until all of a certain vein of coal had been mined and removed. For this lease the taxpayer made a down payment of $50,000.00 and obligated himself unconditionally to pay and did pay a further sum of $51,250.00 in the succeeding year, and further agreed to pay a royalty of 13c per ton, with a minimum annual payment of $26,000.00, to pay all taxes and to account to the lessor for one-half of the net profits. The $50,000.00 payment was made in 1926; the $51,250.00 payment in 1927. The lessee taxpayer sought to deduct these payments as business expenses during the respective years of payment. The Commissioner denied these deductions:

> "• • • • • and apportioned the entire sum throughout the life of the lease, ascertained by taking the petitioner's estimate of the total tonnage of coal in the ground and dividing that by the average tonnage of coal taken out per year. He gave as his reason therefor that those amounts represented a bonus 'paid in connection with the at-

taining of the lease and should be capitalized and the cost recovered over the life of the asset'."

The Board of Tax Appeals upheld this view, as did the Circuit Court. That Court said:

> "It is clear that the payments of $50,000.00 in 1926 and $51,250.00 in 1927 did not constitute rental payments for these respective years, but together represented the payment of a bonus or rental in advance for the entire term of the lease, the length of which was determinable by the quantity of coal in the ground divided by the annual average output. The lease was to run until exhaustion of the coal. It is clearly evident, therefore, that those sums, together with the other payments specified in the lease, constituted the consideration for a lease during the entire period, and that, under the law and the regulations, those sums must be apportioned as an expense over the whole term of the lease, and are not deductible as a business expense of the years in which they were paid. Duffy v. Central R. Co., 268 U. S. 55, 45 S. Ct. 429, 69 L. Ed. 846; Galatoire Bros. v. Lines (C. C. A.), 23 Fed. (2d) 676."

Here the treatment accorded these cash payments followed exactly the treatment which has always been accorded the bonus paid for oil and gas leases. It is income to the lessor, cost to the lessee, recoverable over the life of the lease through depreciation or amortization. Here, too, the payments were treated in exactly the same way as Perkins treated the $155,000.00 in cash and notes which were paid to Branson & Hammond. But in the *Baton Coal Company* case, in the

case of the ordinary oil and gas lease, and, we say, in the Perkins case here, the ordinary royalties, the minimum annual royalties, or those sums equivalent to ordinary royalties involved in this case are deductible as an expense in the year involved if they ever reach the income of the lessee, and nothing in the *Baton Coal Company* case hints to the contrary.

The case of *Jefferson Gas Coal Co. v. Commissioner of Internal Revenue*, 52 Fed. (2d) 120, decided by the Third Circuit on August 19, 1931, was the next case cited by the Eighth Circuit Court in the *Comar Oil Company* case.

There the question involved was whether the instrument under consideration was actually a lease or was a contract of sale. It was executed in 1920. It covered coal lands. It provided for ten annual payments arrived at by fixing a so-called royalty of 12c per ton upon a minimum tonage sufficient to produce each year $31,000.00. If the so-called lessee did not mine that tonnage, it was nevertheless required to pay the specified sum. If it mined more, the additional royalty, so-called, of 12c was to be paid, but this excess payment was to be credited upon the total fixed obligation of $310,000.00. And when the so-called lessor received a total of $310,000.00, he was obligated, for an additional consideration of $1.00, to execute and deliver a deed in fee simple. The question was whether or not the so-called annual royalties were really such or whether the instrument was a contract of sale so that the entire $310,000.00 should be treated as cost of the

land recoverable as any other cost and not to be deducted when paid.

The Third Circuit Court said:

> "If this contract was a lease and the annual payments of $31,000.00 were rentals, then under the act the deduction should have been allowed as claimed, but if this so-called lease was in fact a contract of sale, and the annual payments were capital expenditures, then a deduction for the value of the coal actually mined only should have been allowed."

The first portion of this quotation states a princple directly opposed to that announced in the *Comar Oil Company* case. In the *Comar* case the Court expressly stated that such rentals were not deductible. In the case under consideration the Third Circuit Court said that they were deductible if the instrument was a lease and the annual payments were rentals. The Court then went ahead to hold that the real character of the instrument should be determined from the intention of the parties as gathered from a fair interpretation of the instrument as a whole, and that:

> "Looking at the instrument as a whole and the object sought to be obtained, that it is a contract of sale of coal in place and not a lease is inescapable."

Here there was a fixed enforceable obligation to pay $310,000.00 over a period of ten years, and this regardless of whether a single ton of coal had been mined from the property. This, coupled with the pro-

vision that upon payment of the sum the payor was to receive a deed, clearly distinguishes that case from the one which we are considering.

The last court decision cited in the *Comar Oil Company* opinion was that of *Davison v. Commissioner*, 60 Fed. (2d) 50, decided by the Second Circuit on July 11, 1931.

In the *Davison* case the taxpayer had in December, 1923, paid $8,000.00 for an assignment of a building lease on property which had been sublet and which could be expected to produce about $1,800.00 a year for about 2½ years. The lease so acquired expired in July, 1926, but it contained an option to purchase the property, which option the taxpayer exercised. The question presented was whether all, a portion, or none of the $8,000.00 so paid for the lease could be offset against the rentals received by Davison from December, 1923, to the expiration of the lease in 1926. The Court held that a certain portion of these payments could be so applied.

> "So much of it as represents the cost of acquiring the leasehold should be regarded as an exhaustible capital investment returnable by annual deductions spread over the term of the lease."

And it then proceeded to determine what would be a fair portion of the total $8,000.00. Here is nothing more than an application of the principle that the bonus paid to acquire a leasehold over a period of years is not to be treated as a business expense entirely applicable to the year of payment, but as to the lessee or the one

making the payment this expenditure is to be returned through annual deductions over the term of the lease.

In addition to the cases by the various Circuit Courts above discussed, the Eighth Circuit Court cited in the *Comar Oil Company* case three decisions of the United States Board of Tax Appeals.

The first of these is the case of *Charles H. Merillat v. Commissioner*, 9 B. T. A. 813. The petitioner there held certain oil and gas leases on Indian lands in Oklahoma under which he was required to pay annually, in lieu of drilling and producing from the particular tract, certain payments based on acreage, sometimes referred to as advance royalties and sometimes referred to as rentals. These payments he claimed to be deductible in the year when made. This contention was allowed and in allowing it the Board reached a conclusion directly at variance to that reached by the Court in the *Comar* case. The Board said:

> "We are of the opinion that the total payments of $1,203.45 itemized in the findings of fact constitute rentals and as such are deductible under section 214(a) (1) of the Revenue Act of 1921, which provides that in computing net income there shall be allowed as deductions rentals or other payments required to be made as a condition to the continued use or possession, for purposes of the trade or business, of property to which the taxpayer has not taken or is not taking title or in which he has no equity.
>
> "Some of the payments were termed in the leases as 'advanced royalty' and by the express pro-

visions of the leases they could not be credited against any production other than that of the current year. Under such circumstances, we believe the amounts paid as such are deductible in the current taxable year."

Here the Board treated as deductible payments which were termed advanced royalties, even though the customary rule as to the ordinary bonus or advanced royalty is, in so far as lessee is concerned, to capitalize same and recover it through amortization or depletion. This distinction is made because such advanced royalties could only be applied against ordinary royalties, if any there were, during the current year. So in our case, if we treat the amounts received by Branson and Hammond as coming from Perkins rather than from the property itself and from the sale of the oil by them, as we contend should be done, such payments would be deductible because they relate to current operations and confer no benefit directly related to either later or earlier years. In this sense they could constitute one of the ordinary burdens of current operation.

The next Board of Tax Appeal case is *Kekaha Sugar Co., Ltd. v. Commissioner*, 13 B. T. A. 690. This taxpayer was a Hawaiian corporation engaged in the business of growing sugar. It leased land for this purpose. Its lease provided that the rental should be paid in sugar, but it was customary for the lessee to market the sugar and pay the lessor the market value. It seems that the planting, cultivating and harvesting of the sugar cane extended over three years. In 1918 a large sum was paid as rental, 1/3rd of which was charged to

the crop harvested that year and the other 2/3rds in equal amounts to the crops harvested in the two succeeding years. The Board had for consideration the propriety of allowing the taxpayer to deduct in 1920 1/3rd of the rental which it had paid in 1918. It refused to allow this to be done saying:

> "We are of the opinion that the rental is a direct charge against the crop from which it is paid and is deductible as a part of the cost of that crop. It follows that the Commissioner was correct in refusing to allow a deduction in 1920 of $38,053.22 of the amount paid in 1918, and in refusing to allow that amount to be included in earned surplus as a part of the cost of the 1920 crop."

If an analogy can be found between sugar and oil it would seem that this decision supports the position that all oil delivered by Perkins for the account of Branson and Hammond constituted a direct charge against operation for the year in which delivery was made. It does not even tend to support the proposition in respect to which it was recited by the Eighth Circuit, that is, that rentals and royalties paid by the lessee are a part of his gross income and that the custom has been to include them as such for tax purposes, and that oil royalties paid are customarily included as a part of the gross income of the lessee.

The last case cited was *W. P. Ferguson v. Commissioner*, 20 B. T. A. 130. This case involved three questions. One was whether or not the bonus received by Ferguson for oil and gas leases made by him on

lands owned by him and located in Texas should be taxed as ordinary income or as capital gain. The Board held that such bonuses were to be taxed as ordinary income. This case went to the Circuit Court of Appeals for the Fifth Circuit before the *Harmel* case reached that Court, and the Board's decision upon this phase of the case was reversed by the Fifth Circuit. The Government did not seek a further review of the question. Later the Fifth Circuit reached the same conclusion in the *Harmel* case, and it was brought before this Court, where the view of the Board to the effect that such bonuses constituted ordinary income to the lessor was upheld.

The second question was whether or not the bonuses which Ferguson so received and ordinary royalties received constituted separate or community income, the land covered by the leases and from which the royalties were derived being Ferguson's separate property. The Board held, primarily upon the authority of *Stephens v. Stephens*, 292 S. W. 290, a decision by a Texas Court of Civil Appeals, that such royalties and bonuses constituted separate property because under Texas law they represented a sale of a part of the corpus of the property rather than revenue therefrom. This portion of the decision was affirmed by the Circuit Court of Appeals for the Fifth Circuit. It is interesting to note that on this phase of the case, that is, in determining to whom certain property or income belonged, the Board and Court applied the State law, but when the question was as to how that income was to be taxed to the person to whom it belonged the Board and

this Court disregarded State rules and looked to the Taxing Act in order to determine that question.

The third question involved in the *Ferguson* case related to the earned income credit to which he was entitled. It can have no possible application here.

No where in the opinion is there any discussion as to how royalties or bonuses paid by a lessee, or one similarly situated, are to be treated in such a one's tax return. That is the question with which we are here concerned and with which the Court was concerned in the *Comar* case. And here again is another citation which does not support the proposition under which the Eighth Circuit Court of Appeals cited it.

APPENDIX C

The distinction which the Bureau of Internal Revenue attempts to make between assignments such as those involved in the case at bar and others is illustrated by the following excerpts from a revenue agent's report made after a customary and routine examination of a taxpayer's return and its books and records. This particular taxpayer was Pace Petroleum Company, Inc., a Texas corporation, with its office in Wichita Falls, Texas. On June 14, 1934, it and a co-owner of certain oil and gas leases covering lands in Texas executed an instrument sufficiently described by the following excerpts:

> "We, F. P. Pace, as the owner of an undivided 1/8 interest in the property hereinafter described, and Pace Petroleum Company, Inc., a corporation duly incorporated as such under the laws of the State of Texas, as the owner of a 7/8 interest in the property hereinafter described, for and in consideration of the sum of $249,000.00, cash in hand paid, receipt of which is hereby acknowledged, and subject to the reservation of oil as hereinafter set out, have bargained, sold, transferred and assigned, and by these presents do bargain, sell, transfer and assign, unto Fain-McGaha Oil Corporation, a corporation duly incorporated as such under the laws of the State of Texas, the following described oil and gas leases and leasehold estates, etc."

There followed a description of the leases and the lands covered thereby, and immediately thereafter was the following paragraph:

"Notwithstanding any of the above, there is hereby reserved by the grantors and not conveyed 7/16 of the oil to be produced from the above described oil and gas leases (1/8 thereof as the property of and for the benefit of F. P. Pace, and 7/8 thereof as the property of and for the benefit of Pace Petroleum Company, Inc.) until there shall have been received by the grantors from said 7/16 of the oil, based upon its posted market value as of the date sold to the pipe line company or companies taking the oil, a sum equalling $225,000.00, plus a sum equalling interest at the rate of six per cent per annum, computed on the unpaid balance upon said $225,000.00 at the end of each calendar month * * * if and when the grantors, their heirs, successors, executors, or assigns, shall have received from said oil reservation said sum of $225,000.00, net, plus said item equalling six per cent interest, calculated as above, then all further rights of the grantors shall immediately and ipso facto cease."

As to this transaction the revenue agent said in his report:

"During the taxable year taxpayer sold the Arnold and Green leases in Archer County, Texas, to Fain-McGaha Oil Corporation. The consideration received was, for this taxpayer's 7/8 of the working interest $410,375.00, payable, $217,875.00 cash and $192,500 in oil from 1/2 of the production of the leases. The $192,500.00 payable in oil appears to be a true reservation of oil in place."

The engineer revenue agent who reported upon the

engineering and depletion questions involved in the transaction said in his report:

> "As taxpayer did not sell all of its interest in the property, the cost should be allocated between the part sold and the part retained. As the part retained is 1/2 of the oil (it appears to be equivalent to an overriding interest, due to the size of the payment), 1/2 of the cost is allocated to the part sold and 1/2 to the portion retained. See R. A. R. for computation of the profit on this sale on the above basis. The taxpayer is entitled to percentage depletion on the income from the reserved interest, such depletion being in excess of depletion based on the cost of this interest."

Thus it will be seen that the Bureau of Internal Revenue makes most important distinctions in the treatment of transactions which, from a practical standpoint, cannot be distinguished. Under one type of instrument the Bureau readily grants the holder and recipient of the oil payment depletion with respect thereto and excludes the proceeds from the sale of the oil applicable to the oil payment or reservation from the income of the operator. In the other type of case, like that now before the Court, the Bureau of Internal Revenue tries to treat the amount received by the oil payment holder as additional consideration, denies him depletion with respect thereto—regardless of the fact that various circut courts have expressly held such oil payment holder entitled to depletion—and includes the proceeds from the oil applicable to the oil payment in the income of the operator.

Although the fact that there is no real distinction between the two types of instruments and no justification for this different treatment has been strenuously urged by the Respondents at all stages of this proceeding, the Government has never seen fit to attempt to explain or justify the distinction, and the brief filed by them in this Court follows this same policy.

SUPREME COURT OF THE UNITED STATES.

No. 824.—October Term, 1936.

W. A. Thomas, Collector of Internal Revenue, Petitioner, vs. J. J. Perkins et al.	On Writ of Certiorari to the United States Circuit Court of Appeals for the Fifth Circuit.

[June 1, 1937.]

Mr. Justice Butler delivered the opinion of the Court.

Respondents, husband and wife, sued in the district court for northern Texas to recover a portion of the tax they paid for 1933 on their community income. In respect of the amount now in controversy, that court gave judgment for defendant (15 F. Supp. 356); the Circuit Court of Appeals reversed (86 F. (2d) 954) and, its decision being in apparent conflict with that of the Circuit Court of Appeals for the Eighth Circuit in *Comar Oil Co.* v. *Burnet*, 64 F. (2d) 965, this court granted the collector's petition for a writ of certiorari. — U. S. —.

Hammonds and Branson owned oil and gas leases on undeveloped lands in Texas which provided for a royalty of one-eighth. They assigned to the Faith Oil Company which was principally owned by Green and Perkins. In taking the assignment the company acted for itself to the extent of one-fourth and for Green and Perkins to the extent of three-eighths each. Later it transferred its interest to Perkins. So far as concerns the question here presented, Perkins may be treated as sole assignee of Hammonds and Branson. The assignment recites that they are owners of all rights under or incident to the leases and declares that "in consideration of the sum of Ten Dollars ($10.00) cash[1] . . . and of the further sum of Three Hundred Ninety Five Thousand Dollars ($395,000.00) to be paid out of the oil produced and saved from the . . . lands, and to be one-fourth of all the oil produced and saved . . . until the full sum . . . is paid, we . . .

[1]Contemporaneously with the assignment there was paid $105,000 in cash and $50,000 in notes.

do hereby bargain, sell, transfer, assign, and convey all our rights, title, and interest in and to said leases and rights thereunder".

After description of the lands and leaseholds, the assignment provides that the oil payment shall be made to the assignors, Hammonds and Branson, each to receive one-half thereof, "out of the oil produced and saved from" the leased premises, "which payments shall be made by the pipe line company or other purchaser of said oil, and shall be one-fourth (¼) of all the oil produced and saved from the above described land, until the full sum . . . is fully paid". It is understood and agreed that the $395,000 "is payable out of oil only, if, as and when produced from said lands above described, and said oil payment does not constitute and shall not be a personal obligation of the assignee, its successors or assigns . . . The oil payment . . . shall bear none of the expenses of the development of said leases or any other burden". The instrument does not purport to reserve a lien.

Perkins drilled wells on the leased lands and in 1933 produced oil; the assignors received substantial amounts to apply on the payment to be made them; the oil was run from the wells into tanks on the leased premises from which it was taken by pipeline companies purchasing the oil. Each purchaser required and was furnished a division order executed by all the interested parties. By such orders assignors authorized purchasers to receive from the wells one-fourth of the oil and declared that the oil run should become the property of the purchasers as soon as received by them. In accordance with the orders, purchasers made payments directly and proportionately to the owner of the royalty reserved in the lease, to assignors, and to assignee. The last could not collect for any portion of the oil applicable to the oil payment to be made assignors.

In their tax return for 1933 respondents, Perkins and wife, did not include in income any part of the proceeds that went to assignors. But the commissioner charged the amounts received by the assignors to the respondents and allowed the latter depletion in respect of the same. At the trial it was proved that the long-established practice of the bureau was not to require the operator of an oil and gas lease to include as a part of his income the royalties payable in kind to the lessors. But where they were payable

in cash the operator included the proceeds of all the oil and took as an offsetting deduction the amount of royalties paid. It was admitted that, if the assignors' payments are excluded, the depletion allowed respondents should be correspondingly reduced.

The question is whether respondents' gross income should include moneys paid to assignors by purchasers of the oil.

We need not decide whether technical title to the oil while in the ground was in assignors, or in assignee. The federal income tax Act is to be given a uniform construction of nation-wide application except insofar as Congress has made it dependent on state law.[2] The granting clause in the assignment would be sufficient, if standing alone, to transfer all the oil to the assignee. It does not specifically except or exclude any part of the oil. But it is qualified by other parts of the instrument. The provisions for payment to assignors in oil only, the absence of any obligation of the assignee to pay in oil or in money, and the failure of assignors to take any security by way of lien or otherwise unmistakably show that they intended to withhold from the operation of the grant one-fourth of the oil to be produced and saved up to an amount sufficient when sold to yield $395,000.[3]

The construction that the parties put upon the assignment makes for the same conclusion. There is no suggestion that, having taken title, the assignee transferred any of the oil back to assignors. The division orders designated, and so served to indicate ownership of, the quantities belonging to each of the interested parties. And, in the circumstances, the orders given and proceeds received by assignors necessarily covered and were derived from oil not transferred by the assignment.

Our decision in *Palmer* v. *Bender*, 287 U. S. 551, supports the view that the assignment did not transfer the oil in question. We there construed § 214 (a) (10), Revenue Act of 1921, 42 Stat. 241, which directed a reasonable allowance for depletion in the case of oil and gas wells "according to the peculiar conditions in each case"

[2] Lynch v. Alworth-Stephens Co., 267 U. S. 364, 370. Corliss v. Bowers, 281 U. S. 376, 378. Tyler v. United States, 281 U. S. 497, 503. Burnet v. Harmel, 287 U. S. 103, 110. Palmer v. Bender, 287 U. S. 551, 556. Burnet v. Guggenheim, 288 U. S. 280, 284. Helvering v. Falk, 291 U. S. 182, 188.

[3] Sheffield v. Hogg, 124 Tex. 290. See Waggoner Estate v. Sigler Oil Co., 118 Tex. 517. Hager v. Stakes, 116 Tex. 453. Stephens County v. Mid-Kansas Oil & Gas Co., 113 Tex. 160. Texas Co. v. Daugherty, 107 Tex. 227.

and "that such depletion allowance based on discovery value shall not exceed the net income, computed without allowance for depletion, from the property upon which the discovery is made . . . In the case of leases the deductions allowed . . . shall be equitably apportioned between the lessor and the lessee."

The taxpayer, Palmer, was a member of a partnership that acquired oil and gas leases, discovered oil, executed a writing conferring on a company the right to take over a part of the leased property in consideration of a present payment of a cash bonus, and future payments to be made "out of one-half of the first oil produced and saved" to the extent of $1,000,000, and an additional "excess royalty" of one-eighth of all the oil produced and saved. The writing declared that the partnership "does sell, assign, set over, transfer and deliver . . . unto the" oil company the described leased premises.

In his tax return, Palmer reported his share of the income derived by the partnership from the bonus payment and oil received under its contract with the oil company and, relying on § 214 (a) (10), made a deduction for depletion based on value of oil in place on the date of discovery. The commissioner refused to allow the deduction on the theory that the transaction was a sale of the leases by the partnership, and that the only allowable deduction was one based upon the cost of the property. As cost was less than the discovery value, the commissioner's allowance of depletion was less than that claimed by Palmer and the tax was correspondingly greater. He paid it, and sued the collector to recover the amount by which the commissioner's ruling operated to increase his burden.

The district court upheld the commissioner's ruling, the Circuit Court of Appeals affirmed, this court reversed. We said (pp. 557-558): "The language of the statute is broad enough to provide, at least, for every case in which the taxpayer has acquired, by investment, any interest in the oil in place, and secures, by any form of legal relationship, income derived from the exaction of the oil, to which he must look for a return of his capital . . . . Similarly, the lessor's right to a depletion allowance does not depend upon his retention of ownership or any other particular form of legal interest in the mineral content of the land. It is enough if, by virtue of the leasing transaction, he has re-

tained a right to share in the oil produced. If so he has an economic interest in the oil, in place, which is depleted by production. Thus, we have recently held that the lessor is entitled to a depletion allowance on bonus and royalties, although by the local law ownership of the minerals, in place, passed from the lessor upon the execution of the lease . . . Thus, throughout their changing relationships with respect to the properties, the oil in the ground was a reservoir of capital investment of the several parties, all of whom . . . were entitled to share in the oil produced".

Thus in that case we held assignors' mere stipulation for royalty out of oil operated to save to them an economic interest in the oil sufficient to entitle them to deduct from their income derived from the oil an allowance for depletion. If Palmer had retained no interest in the oil he would have been entitled to no deduction on account of depletion. Ownership was essential. The assignee was not entitled to income from Palmer's share of the oil nor to deduct from the income it received from its own interest any part of the depletion allowance that was attributable to Palmer's interest.

Helvering v. *Twin Bell Syndicate*, 293 U. S. 312, construed depletion provisions in the Revenue Act of 1926 which so far as concerns ownership are not to be distinguished from corresponding provisions considered in *Palmer* v. *Bender, supra*. Section 204 (c) (2) declared that in the case of oil and gas wells "the allowance for depletion shall be 27½ per cent of the gross income from the property during the taxable year". Section 234 (a) (8) required the deductions allowed to be equitably apportioned between the lessor and lessee. The taxpayer, assignee of the lease, extracted substantial quantities of oil. By the terms of the lease and assignment he was obligated to pay royalties in cash or kind totalling one-fourth of the oil. He claimed that gross proceeds of all the oil should form the basis for computation of the allowance for depletion. The commissioner ruled that the deduction should be limited to 27½ per cent. of the gross production less royalties. The board of tax appeals upheld that ruling; the Circuit Court of Appeals reversed the board; we sustained the commissioner. Our opinion shows that the phrase, "income from the property", means income from oil and gas only; that, where the lessee turns over royalty

oil in kind to the lessor, the amount retained by lessee is the basis for his computation of depletion and the royalty oil is the basis for that allowable to lessor. In that connection we suggested that Congress did not intend a different result where the lessee sells all the oil and pays over the royalty in the form of cash. And in approval of the commissioner's ruling we said (p. 321): "The apportionment gives respondent 27½ per cent. of the gross income from production which it had the right to retain and the assignor and lessor respectively 27½ per cent. of the royalties they receive. Such an apportionment has regard to the economic interest of each of the parties entitled to participate in the depletion allowance. Compare *Palmer* v. *Bender*, 287 U. S. 551, 558."

As in the earlier of these cases the assignor was entitled to deduct depletion from income he received from his interest in the oil, so in the later one the assignee was not entitled to deduct from income received from its share an allowance for depletion attributable to the assignor's interest. The owner of an interest in the deposit is entitled to deduct for depletion of the part producing his income but may not deduct for depletion of a share belonging to another.

As Hammonds and Branson, the assignors in this case, would be entitled to an allowance for depletion in respect of the oil sold out of their share,[4] the income from that interest is not chargeable to respondents, Perkins and wife. It follows that the commissioner erred in including in their income the payments made by purchasers to assignors for their share of the oil.

Affirmed.

[4] Revenue Act of 1932, §§ 23 (l), 114(b) (3), 47 Stat. 181, 202. Palmer v. Bender, 287 U. S. 551. Helvering v. Twin Bell Syndicate, 293 U. S. 312.

SUPREME COURT OF THE UNITED STATES.

No. 824.—October Term, 1936.

W. A. Thomas, Collector of Internal Revenue, Petitioner, *vs.* J. J. Perkins, et al.	On Writ of Certiorari to the United States Circuit Court of Appeals for the Fifth Circuit.

[June 1, 1937.]

Mr. Justice Stone and Mr. Justice Cardozo think the oil and gas produced by the assignee of the lease, and their proceeds, were his income and not any the less so because he agreed to apply a part to payment of the purchase price of the lease, and gave an equitable lien to secure the payment. Whether the purchase price, when paid, represented a capital gain taxable to the assignors, and whether in that case their interest would be subject to a depletion allowance under our decision in *Palmer* v. *Bender*, 287 U. S. 551, are questions irrelevant to the present issue. The judgment should be reversed.